CAN FINANCIAL INSTITUTIONAL INVESTORS LEGALLY SAFEGUARD AMERICAN STOCKHOLDERS?

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"[B]eing managers of other people's money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which partners in a private co-partner frequently watch over their own . . . Negligence and profusion therefore, must always prevail more or less in the management of affairs of a [joint stock] company."[1] (Adam Smith)

INTRODUCTION

Reading the popular press, one can easily believe that corporate America is in terrible shape with the failures at Enron,[2] WorldCom,[3] Tyco,[4] Adelphia,[5] Global Crossing,[6] Freddie Mac,[7] Boeing[8] and others. The primary cause of these failures,

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1. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 264-65 (Edwin Cannan ed., University of Chicago Press 1976) (1776).

2. Matthew Grimm, *Everybody loved Enron (False Consciousness)*, BRANDWEEK, Mar. 6, 2006, at 23.

3. Richard Sauer, *A New Worldcom Order*, WALL ST. J., September 30, 2003, at B2.

4. Andrew Ross Sorkin, *Tyco Finds $1 Billion More in Irregularities*, N.Y. TIMES, May 1, 2003, at C8.

5. Andrew Ross Sorkin, *Adelphia Is Next in Parade of Fraud Trials*, N.Y. TIMES, Feb. 23, 2004, at C1.

6. Almar Latour, *Global Crossing SEC Deal Expected*, WALL ST. J., Mar. 22, 2004, at A8.

7. Jonathan D. Glater, *Freddie Mac to Aid Effort to Recover Millions From Ex-Officers*, N.Y. TIMES , Sept. 13, 2005 at C5.

8. Leslie Wayne, *More Setbacks for Boeing*, N.Y. TIMES, January 15, 2005, at C1.

according to the business press, is based in weaknesses in corporate boards and corporate governance rules. These perceived failures have played an important role in inducing legislative change – in the form of the Sarbanes-Oxley Act of 2002[9] – and regulatory change,[10] including new governance guidelines from the SEC,[11] NYSE[12] and NASDAQ[13].

The standard argument one hears is that boards of directors who have always been eager to punish incompetence are not as eager to spot or investigate or prosecute alleged criminality.[14] They will complain feverishly when quarterly performance numbers are depressed but will ignore situations where the numbers are either fraudulent at face value or questionable, at best.[15] They will use stocks and stock options to align management's interests with those of shareholders but ignore the inevitable incentive that this creates to artificially drive up stock prices with questionable or false promises.[16] The old shortsighted credo – "take the money and run" – is alive and well in corporate America and is the current envy of Europe.[17] How did we get to this situation? Is caused by a lack of monitoring? Is it poor governance or greed?

The article looks at the changes in corporate governance in the U.S. since 1980 and focuses on the purported savior of corporate America, the financial institutional investor. It has been argued that the large increase in the shareholdings of institutional investors will result in greater shareholder repre-

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9. Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

10. Marco Becht, Patrick Bolton & Ailsa Roell, *Corporate Governance and Control*, *in* HANDBOOK OF ECONOMICS AND FINANCE 1, 4-8, 13-19 (George M. Constantinides, Milton Harris & Rene M. Stulz eds., 2002).

11. Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

12. NYSE, Inc., Listed Company Manual § 303A (2004).

13. NASDAQ, Inc., Marketplace Rules R. 4350(c)-(d) (2006).

14. Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 811 (2001).

15. *Id.* at 807.

16. John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW 1403, 1413-14 (2002).

17. *See* Terence L. Blackburn, *The Unification of Corporate Laws: The United States, the European Community and the Race to Laxity*, 3 GEO. MASON INDEP. L. REV. 1 (1994).

sentation by professional investors.[18] Increased shareholdings, of course, raises questions concerning the capacity of institutional investors to provide unbiased monitoring. In evaluating this capacity we show that, contrary to popular belief, this investor group – composed of banks, financial institutions, insurance companies and pension funds, are all legally limited in their role as monitoring agents.

This article will show that despite the changes in the past 20 years, allowing for financial institutional investor to play a more crucial role,[19] the institutional investor has in fact been limited by the legal system. For example, portfolio rules, anti-networking rules, and other fragmenting rules disable financial institutional investors from systematically taking control blocks.[20] Moreover, banks and bank holding companies have repeatedly been prohibited from owning control blocks of stock or from affiliating with investment banks that own control blocks.[21] In addition, insurance companies were for quite

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18. Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 886-88 (1991).

19. *See* Paul A. Gompers & Andrew Metric, *Institutional Investors and Equity Prices*, 116 Q. J. ECON. 229, 239 (2001) ("Large institutions, when compared with other investors, prefer stocks that have greater market capitalizations, are more liquid, and have higher book-to-market ratios and lower returns for the previous year."); James M. Poterba & Andrew A. Samwick, *Stock Ownership Patterns, Stock Market Fluctuations, and Consumption*, *in* 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 295, 295-357 (William C. Brainard & George L. Perry eds., 1995); Mark R. Huson, Robert Parrino & Laura T. Starks, *Internal Monitoring Mechanisms and CEO Turnover: A Long-Term Perspective*, 56 J. Fin. 2265, 2265-97 (2001).

20. See discussion *infra* Part IV.

21. Bray Hammond, *Politics and the Growth of Banking, 1791-1816*, *in* BANKS AND POLITICS IN AMERICA FROM THE REVOLUTION TO THE CIVIL WAR 149-55 (1957); California Bank v. Kennedy, 167 U.S. 362, 366-67 (1897); National Bank Act of Feb. 25, 1863, § 11, 12 U.S.C. § 24 (1998). State member banks of the Federal Reserve System were later similarly restricted. Banking Act of 1933 (Glass-Steagall), § 5(c), 12 U.S.C. §335 (1998); Banking Act of 1933 (Glass-Steagall), § 16, 12 U.S.C. § 24 (1998); Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 207, 214-21 (1984) (upholding FRB's authorization of Bank of America to acquire Schwab, a securities dealer). *See also* J.P. Morgan & Co., [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 87,554 (Jan. 19, 1989) (FRB approves application of commercial bank to establish underwriting affiliate); Bankers Trust New York Corp., 75 Fed. Res. Bull. 829 (1989) (FRB approves application of commercial banks to engage in some brokerage activities); and 12 C.F.R. § 9.18(b)(9)(ii) (1990); and 1 STAFF OF HOUSE SUBCOMM. ON DOMESTIC FI-

some time prohibited from owning any stock, and portfolio rules still restrict their ability to obtain controlling shares.[22] Furthermore, mutual funds cannot deploy more than a fraction of their portfolio in a concentrated position as buying more than 5% of a company triggers onerous rules.[23] Pension funds, on the other hand, are less restricted, but they are fragmented; legal rules make it difficult for pension funds to oper-

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NANCE, COMM. ON BANKING AND CURRENCY, 90TH CONG., 2D SESS., COMMERCIAL BANKS AND THEIR TRUST ACTIVITIES: EMERGING INFLUENCE ON THE AMERICAN ECONOMY 1-4 (Comm. Print 1968) [hereinafter Patman Report]; Clair & Tucker, *Interstate Banking and the Federal Reserve: A Historical Perspective*, FED. RESERVE BANK OF DALLAS ECON. REV., Nov. 1989, at 1, 6-12; Bank Holding Company Act of 1956, § 4(c)(4)-(5), 12 U.S.C. § 1843(c)(5)-(6) (1998). Shares acquired in a fiduciary capacity are not included in the 5% limitation. P. HELLER, FEDERAL BANK HOLDING COMPANY LAW § 4.03(2)(b) (1990). Authority to own nonvoting stock of *public* companies was until recently largely illusory. Public companies could not issue nonvoting stock for most of the post-1956 era because of one-share, one-vote rules. NYSE, Inc., Listed Company Manual §§ 3.11-3.14 (1990).

22. Act of Apr. 27, 1906, ch. 326, 1906 N.Y. Laws 763, 797; Act of Mar. 31, 1951, ch. 400, § 5, 1951 N.Y. Laws 1065, 1070. In 1951, New York law governed 85% of the insurance industry's assets. Bell & Fraine, *Legal Framework, Trends, and Developments in Investment Practices of Life Insurance Companies*, 17 LAW & CONTEMP. PROBS. 45, 46 (1952); N.Y. Ins. Law §§ 1405(a)(6)-(8), 1405(a)(6)(i), 1705(a)(1)-(2) (McKinney 1985 & Supp. 1990). In the 1980s, New York expanded the permissible activities of life insurer subsidiaries. But portfolio rules still limit them: a subsidiary's goodwill is carved out from coverage tests. No more than 2% of a life insurer's assets can go into any subsidiary, and no more than 5% of a life insurer's assets can go into non-New York subsidiaries (another 5% can go into New York subsidiaries). *Id.* §§ 1302(a)(1), 1414(f). Ownership of as little as 5% + of the portfolio company could trigger classification as a subsidiary, thereby triggering the goodwill carve-out and the overall 5% limit on deployment of the life insurer's assets. *Id.* § 107(a)(40). And finally, networking with banks is limited, since insurance companies cannot own banks. *Id.* §§ 1701(a), 1403(c), 1404(a)(13)(B)(i) (no more than 5% of portfolio company's voting stock). *Id.* § 1407(a)(4), 1600-12 (only insurance subsidiaries). *See* N.Y. Ins. Law §§ 1413, 1405(a)(6)-(8) (McKinney 1985 & Supp. 1990) (non-New York insurers must substantially comply with New York law if the insurer wishes to sell policies to New Yorkers); Cal. Ins. Code §§ 1198, 1199 (West 1972); Ill. Ann. Stat., ch. 73, § 737.12(a)(c) (Smith-Hurd Supp. 1990); Tex. Ins. Code Ann. § 3.39.C.3 (Vernon 1981); McCown & Martinie, *State Regulation of Life Insurance Companies*, 27 A. LIFE INS. COUNS. PROC. 8 (1988).

23. 1940 Act § 2(a)(3), 15 U.S.C. § 80a-2(a)(3) (1998); 17 C.F.R. 270.17a-6 (1990); 1940 Act § 17(a)(1)-(2), 15 U.S.C. § 80a-17(a)(1)-(2) (1998). There are some exceptions. *See Id.* § 17(b), 15 U.S.C. § 80a-17(b) (1998).

ate jointly to assert control.[24] And finally, private pension funds are under management control; they are not constructed for a palace revolution in which they would assert control over their managerial bosses.[25]

Thus, the question remains, are we better off? Or should we introduce a cure that would resemble the European or Japanese model?

I.
CORPORATE GOVERNANCE, LEGAL TRADITIONS AND THE RULE OF LAW[26]

In a general sense, in the American view, the primary purpose of the corporation is to make money and increase shareholder value.[27] However, for the majority of the rest of the world, corporate governance has a much broader stakeholder[28] point of view. This view is reflective in the recent Organization for Economic Co-operation and Development ("OECD") report on corporate governance – the general objective of corporate governance is to align the interests of firms with those of society, to balance entrepreneurship with ac-

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24. Employee Retirement Income Security Act of 1974 ("ERISA") § 404, 29 U.S.C. § 1404 (1998); ERISA § 104(1)(C), 29 U.S.C. § 1104(1)(c) (1998) (emphasis added); ERISA § 104(1)(B), 29 U.S.C. § 1104(1)(B) (1998); B. KRIKORIAN, FIDUCIARY STANDARDS IN PENSION AND TRUST FUND MANAGEMENT 290-91 (1989); S. Rep. No. 144, 99th Cong., 1st Sess. 53-58 (1986).

25. B. KRIKORIAN, FIDUCIARY STANDARDS IN PENSION AND TRUST FUND MANAGEMENT 290-91 (1989).

26. This article is in part taken from the draft version of Scheherazade S. Rehman & Frederick V. Perry, *European Corporate Governance Developments And Their Impact On Firm Competitiveness*, (European Union Research Center, Working Paper Series, Fall 2003); and also for general reference and more details see Chew, Donald (ed). Studies in International Corporate Finance and Governance Systems: A Comparison of the U.S., Japan and Europe, Oxford University Press, NY 1997.

27. *See* Ian B. Lee, *Corporate Law, Profit Maximization, and the "Responsible" Shareholder*, 10 STAN. J.L. BUS. & FIN. 31, 32 (2005); Marco Becht, Patrick Bolton & Ailsa Roell, *Corporate Governance and Control*, *in* HANDBOOK OF ECONOMICS AND FINANCE 1, 13-19 (George M. Constantinides, Milton Harris & Rene M. Stulz eds., 2002).

28. William M. Evan & R. Edward Freeman, *A Stakeholder Theory of the Modern Corporation: Kantian Capitalism*, *in* ETHICAL THEORY & BUSINESS 56 (Tom L. Beauchamp & Norman E. Bowie eds., 6th ed. 2001) (stakeholder reflect the interests of all the major players associated with a firm i.e. shareholders, suppliers, employees, trade unions, etc.)

countability and to enable companies to earn a rate of return on investment that generates additional capital.[29]

The corporate governance systems used throughout the world are generally rooted in either the stock market based Anglo-Saxon (outsider) or the more traditional bank-based (insider) European and Japanese governance systems.[30] At present, the Anglo-Saxon system is primarily used in the United States and, with modifications, in the United Kingdom and Ireland.[31] The European system, with country-to-country variations, is practiced in the other EU nations while different versions of the Japanese system are used throughout the Pacific Basin Region.[32] Again it should be mentioned that the concept of corporate governance in the United States, or even in the United Kingdom, that is, in the Anglo-Saxon type of system, is considerably narrower than that in many other countries, especially that of Europe.

There is an extensive literature providing legal, economic and other definitions of corporate governance systems.[33] In

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29. CORPORATE GOVERNANCE: IMPROVING COMPETITIVENESS AND ACCESS TO CAPITAL MARKETS, A REPORT TO THE OECD BY THE BUSINESS SECTOR ADVISORY GROUP ON CORPORATE GOVERNANCE (Organization for Economic Cooperation and Development ed., 1998).

30. *See* Paul J.N. Halpern, *Systemic Perspectives on Corporate Governance Systems, in* CORPORATE GOVERNANCE AND GLOBALIZATION: LONG RANGE PLANNING ISSUES 1-58 (Steven S. Cohen & Gavin Boyd eds., 2000); *See generally* STUDIES IN INTERNATIONAL CORPORATE FINANCE AND GOVERNANCE SYSTEMS: A COMPARISON OF THE U.S., JAPAN AND EUROPE (Donald H. Chew ed., 1997).

31. *See* STUDIES IN INTERNATIONAL CORPORATE FINANCE AND GOVERNANCE SYSTEMS: A COMPARISON OF THE U.S., JAPAN AND EUROPE (Donald H. Chew ed., 1997); *Anglo-Saxon Model: A Critical View*, BANQUE PARIBAS CONJONCTURE, Oct. 2005, 16-29, *available at* http://economic-research.bnpparibas.com/applis/www/RechEco.nsf/ConjonctureByDateEN/1D7F2D42CE54277CC1257 0A7004F8E6A/$File/C0510_A2.pdf?OpenElement.

32. The dominant types of corporate government systems have been extensively discussed in the literature. *See, e.g.*, Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 737-83 (1997); *See generally* CORPORATE GOVERNANCE AND GLOBALIZATION (Stephen S. Cohen & Gavin Boyd eds., 1998); *See also The End of Tycoons*, ECONOMIST, April 29, 2000, at 67-69 (discussing some of the changes in the Pacific Basin Region).

33. Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 737-83 (1997); Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 471-517 (1999); Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 3-27 (2000); OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 37-54 (1995); CORPORATE GOVERNANCE: IMPROVING COMPETITIVENESS AND ACCESS TO CAPITAL

this article such systems are understood in a broader sense, consisting of a set of internal and external arrangements and processes that are shaped by the political, economic, legal and social characteristics and values of societies.

The internal arrangements are comprised of: the type and structure of ownership, company objectives, the nature of the internal decision-making processes, the role of shareholders and other stakeholders, sources of financing, the monitoring, reporting requirements and the managerial incentive system.

The external arrangements consist of political-institutional features, such as the location and distribution of power and the nature of the decision-making processes. They also encompass the economic and, to some extent, the social structures, particularly the degree of competition and flexibility in the product, service, capital and labor markets and the extent of the social safety net. Additional features are the legal traditions, rule of law, and regulatory requirements governing business activities.

Corporate governance can be viewed as the mechanism to minimize the loss of the foregone value of the separation of ownership from the management.[34] Through the institution of the joint-stock company or publicly held corporation, investors are separated from management and, while this separation provides benefits such as the specialization of management functions and diversification of risk across the investor-stakeholder base, there are some significant costs that result from this separation.[35] These costs are associated with the amount of foregone value resulting from the separation of ownership from management and are minimized through ef-

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MARKETS, A REPORT TO THE OECD BY THE BUSINESS SECTOR ADVISORY GROUP ON CORPORATE GOVERNANCE (Organization for Economic Co-operation and Development ed., 1998); OECD Principles of Corporate Governance, 2004, available at http://www.oecd.org/dataoecd/32/18/31557724.pdf; Michael Bradley et al., *Challenges to Corporate Governance: The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads*, 62 LAW & CONTEMP. PROBS. 9, 9-46 (1999); D.K. Denis, *Twenty-five Years of Corporate Governance Research . . . and Counting*, 10 REV. FIN. ECON 191 (2001); Tarun Khanna et al., *Globalization and Corporate Governance Convergence? A Cross-Country Analysis* 4 (Harvard Bus. Sch. Working Paper, No. 02-041, Oct. 30, 2001).

34. *See generally* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

35. *Id.*

fective corporate governance.[36] Investors and other stakeholders use the governance systems to influence managers to take action that allows such stakeholders to realize their particular goals through effective monitoring and incentive systems. These systems may be economically or socially based or be a combination thereof.[37] It is in this sense that corporate governance systems reflect social values.

A corporation must rely on its board of directors and management to watch out for its interests. Without safeguards, managers could use their position to siphon off economic benefits and thereby weaken long-term corporate performance, in turn reducing investment values. The systematic enforcement of safeguards pertaining to corporate activities and governance issues is designed to shape the business environment and the management ethos of companies.[38] Ideally, managers are motivated to obtain financial and other resources on the best possible terms and to use these resources in the most efficient manner.[39]

In accordance with largely worldwide conceptions pertaining to formation and running of a corporation, it is through various legal and economic arrangements and processes that investors and other stakeholders establish firms; select, monitor, reward and otherwise influence managers whom they hire to use; and safeguard and augment their capital. It is the responsibility of governments to provide transparent political, legal and economic environments to protect individuals, firms and society against the misuse of corporate resources or from fraud.

The rapidly expanding globalization of competition and the growing diversity of investor ownership structures, finan-

36. *See* CORPORATE GOVERNANCE: IMPROVING COMPETITIVENESS AND ACCESS TO CAPITAL MARKETS, A REPORT TO THE OECD BY THE BUSINESS SECTOR ADVISORY GROUP ON CORPORATE GOVERNANCE (Organization for Economic Co-operation and Development ed., 1998).

37. *Id.*

38. *See* Marco Becht, Patrick Bolton & Ailsa Roell, *Corporate Governance and Control*, *in* HANDBOOK OF ECONOMICS AND FINANCE 1, 13-19 (George M. Constantinides, Milton Harris & Rene M. Stulz eds., 2002); *See* Paul J.N. Halpern, *Systemic Perspectives on Corporate Governance Systems*, *in* CORPORATE GOVERNANCE AND GLOBALIZATION: LONG RANGE PLANNING ISSUES 1-58 (Steven S. Cohen & Gavin Boyd eds., 2000).

39. *Id.*

cial products, and management methods, together with the ongoing differences in how societies and economies are organized and managed, hinder the formulation of a generally accepted corporate governance system worldwide.[40] Even so, international investors and expanding capital markets are gradually bringing about a degree of convergence.[41] Flexibility, transparency and accountability, for example, are by now generally recognized as crucial governance features.[42] But the political, economic, legal and social contexts still vary from country to country or region to region.

In the narrow sense, corporate governance concerns itself with the relationships among corporate management, the board of directors, and the investors or shareholders. But corporate governance can also consider the relationship between the corporation and other stakeholders, in addition to investors. In a broader sense, corporate governance is formulated and disciplined by laws, regulations, stock market listing rules, commercial customs and public opinion. Differences exist from country to country as to how companies are governed, and the question "whom do we govern the corporation for?" is answered differently.

II.
ANGLO-SAXON VERSUS THE EUROPEAN AND JAPANESE GOVERNANCE SYSTEMS

The main features of the Anglo-Saxon system are dispersed ownership and detailed legal provisions.[43] The rights and responsibilities of investors and other stakeholders are defined by formal rules and applied through legal contracts that

40. Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 335-57 (2001); Paul J.N. Halpern, *Systemic Perspectives on Corporate Governance Systems*, *in* CORPORATE GOVERNANCE AND GLOBALIZATION: LONG RANGE PLANNING ISSUES 1-58 (Steven S. Cohen & Gavin Boyd eds., 2000); Marco Becht, Patrick Bolton & Ailsa Roell, *Corporate Governance and Control*, *in* HANDBOOK OF ECONOMICS AND FINANCE 1, 13-19 (George M. Constantinides, Milton Harris & Rene M. Stulz eds., 2002).

41. Paul J.N. Halpern, *Systemic Perspectives on Corporate Governance Systems*, *in* CORPORATE GOVERNANCE AND GLOBALIZATION: LONG RANGE PLANNING ISSUES 36-49 (Steven S. Cohen & Gavin Boyd eds., 2000). .

42. *Id.*

43. Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 329-57 (2001).

rely on competitive and transparent market transactions. As already alluded to, the primary responsibility of management is to maximize shareholder value.[44] With management compensation tied to profits and stock options, managers are under constant pressure to realize this goal.[45] Failure to do so is quickly reflected by declining share prices in the deep and liquid capital markets. Thus failure is generally visible, and either the shareholders, through voting at the annual meeting, or the Board of Directors, by chastising or replacing management, attempt to correct problems as they arise.[46] The major strengths of the system are its flexibility, transparency and accountability, enabling corporate managers rapidly to respond to competitive challenges and shareholder demands. Its disadvantage are the limited influence of stakeholders other than shareholders and the income and wealth gap between managers and workers on the one hand and shareholders and the rest of society on the other hand. Labor unions in particular clamor about this.[47] As measured by conventional macro-economic indicators such as growth, manufacturing productivity and unemployment, the U.S. economy has been ahead of the European Union (EU) economies for most of the 1990s.[48]

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44. *See* Ian B. Lee, *Corporate Law, Profit Maximization, and the "Responsible" Shareholder*, 10 STAN. J.L. BUS. & FIN. 31, 32 (2005).

45. Richard A. DeFusco, Robert Johnson & Thomas Zorn, *The Effect of Executive Stock Option Plans on Stockholders and Bondholders*, 45 J. FIN. 617., 617-627 (1990); William Lazonick & Mary O'Sullivan, *Maximizing Shareholder Value: A New Ideology For Corporate Governance*, 29 ECON. & SOC'Y 13, 18-29 (2000); J. Weimer J. & J.A. Pape, *Taxonomy of Systems of Corporate Governance*, Corporate Governance, 7 CORP. GOV. 152, 154-166 (1999).

46. William Lazonick & Mary O'Sullivan, *Maximizing Shareholder Value: A New Ideology For Corporate Governance*, 29 ECON. & SOC'Y 13, 22-35 (2000); J. Weimer J. & J.A. Pape, *Taxonomy of Systems of Corporate Governance*, Corporate Governance, 7 CORP. GOV. 152, 154-166 (1999).

47. *Anglo Saxon Model: A Critical View*, BANQUE PARIBAS CONJONCTURE, Oct. 2005, 16-29, *available at* http://economic-research.bnpparibas.com/applis/www/RechEco.nsf/ConjonctureByDateEN/1D7F2D42CE54277CC125 70A7004F8E6A/$File/C0510_A2.pdf?OpenElement.

48. It has been a challenge to economists to explain the excellent performance of the U.S. economy during the 1990s. In time, explanations focused on the average annual productivity increase of 2.5% and the contributions of the information technology industry to the rest of the economy. Press Release, U.S. Industrial Conference Board, ITC Driving U.S. Productivity Gains (Oct. 29, 2001) (on file with author). The annual "Economic Report of the [U.S.] President," released in early 2002 made the same point. ECONOMIC REPORT OF THE PRESIDENT TRANSMITTED TO THE CONGRESS, FEBRU-

America's economy, except for one year, maintained an average annual growth rate of more than 3% while the average annual EU growth rate was less than that, also except for one year.[49] As a result, measured by annual revenues earned during the 1990s, of the world's 50 largest high-tech companies 36 were American and only 4 were European.[50] The strong performance of the American firms is usually ascribed to the flexible U.S. economy, liquid capital markets and the effective corporate governance system.[51]

The traditional European style corporate governance system is motivated by a desire for economic stability and social safety, as reflected by the widespread acceptance of welfare states in continental Europe.[52] European welfare states provide a broad and deep social safety net that includes, among others: relatively secure employment, generous unemploy-

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ARY 2002 TOGETHER WITH THE ANNUAL REPORT OF THE COUNCIL OF ECONOMIC ADVISERS 59-60, 96-98 (2002), *available at* (http://www.gpoaccess.gov/usbudget/fy03/pdf/2002_erp.pdf). It should be pointed out, however, that during the 1990s a number of individual EU economies have done well not only in terms of the levels of productivity and GDP per capita, but also in terms of productivity growth. But these relatively successful performers were comprised of small states such as Ireland, a country which led the group. The large nations, generating over 80% of EU GDP, included, for example, Germany, the United Kingdom, France, Italy and Spain; these countries did not do well. *Compare* International Monetary Fund, International Financial Statistics (1990), *with* International Monetary Fund, International Financial Statistics (2004).

49. International Monetary Fund, International Financial Statistics (1990-2004).

50. *New Economy: Catch Up If You Can*, ECONOMIST, September 21, 2000, at 77.

51. Occasionally, the system breaks down, particularly the transparency, disclosure and monitoring aspects of the system. Recent of this breakdown examples include Long-Term Capital Management in 1998 and the Enron Corporation in 2001- 2002. *See generally* Kevin Dowd, *To Big To Fail? Long-Term Capital Management and the Federal Reserve* (CATO Inst., Briefing Paper, No.52, CATO Institute, 1999); *Timeline of Enron's Collapse*, WASH. POST, Sept. 30, 2004.

52. Lucian Cernat, *The Emerging European Corporate Governance Model: Anglo-Saxon, Continental, or Still the Century of Diversity*, 11 J. EUR. PUB. POL'Y 147, 150-62 (2004); Bernhard Ebbinghaus, *Does a European Social Model Exist and Can It Survive?*, *in* THE ROLE OF EMPLOYER ASSOCIATIONS AND LABOUR UNIONS IN THE EMU 1-26 (Gerhard Huemer, Michael Mesch, & Franz Traxler eds., 1999); Anton Hemerijck, *The Self-Transformation of the European Social Model(s)*, *in* WHY WE NEED A NEW WELFARE STATE 193-213 (G. Esping-Andersen et al. eds., 2002).

ment and other benefits, regulated working conditions and extensive public pension system benefits, all financed through high taxes.[53] The system is characterized by inflexible economic structures comprised of: regulated product-service, capital and labor markets, high taxes, generous public spending and managerial systems that are risk averse.[54] Over time, this had brought about a corporate governance system that sustains and, in turn, is sustained by such economic features and managerial practices.[55] The poor performance of European firms during the 1990s is usually explained in terms of the traditional European desire for economic stability and social safety as reflected by the widespread acceptance of the welfare states following World War II.[56] According to a report by the Economic Advisory Group of the EU Commission, of the 100 top companies in the broadly defined high-tech "New Economy" the EU nations are represented by only six firms, three of them Scandinavian.[57]

The Japanese corporate governance system is bank and stakeholder based with the "keiretsu," a unique form of industrial organization, playing a major role.[58] A "keiretsu" is a network of businesses made up of a core company and/or a main bank and associated firms that maintain concentrated cross-ownership arrangements.[59] It represents a coalition of stake-

53. Anton Hemerijck, *The Self-Transformation of the European Social Model(s), in* WHY WE NEED A NEW WELFARE STATE 193-213 (G. Esping-Andersen et al. eds., 2002).

54. *Id.*

55. *Id.*

56. *Id.*

57. Martin Wolf, *Hard Work Versus Joie de Vivre: Some European Countries Exceed the U.S. in Output per Head but the Continent Spends More of its Wealth on Leisure,* FIN. TIMES, February 20, 2002, at 23.

58. CHICARA HIGASHI & G. PETER LAUTER, THE INTERNATIONALIZATION OF THE JAPANESE ECONOMY 313-338 (1990); MICHAEL E. PORTER, HIROTAKA TAKEUCHI & MARIKO SAKAKIBARA, CAN JAPAN COMPETE? 18-21, 69-99, 150-52 (2000); GERALD MEIER, THE INTERNATIONAL ENVIRONMENT OF BUSINESS: COMPETITION AND GOVERNANCE IN THE GLOBAL ECONOMY 272-273 (1998).

59. In times of high economic growth and corporate profits (1970-1990) the system had worked well because it insured stability in all business relations. But in times of low growth and profits (1991-2005), which requires restructuring and other related corporate changes, the system's stability turns into rigidity. Consequently, the Japanese are currently reviewing the system as part of an overall examination of their economy. Changes, however, are slow in coming. MICHAEL E. PORTER, HIROTAKA TAKEUCHI &

holders without carefully delineated authority lines among, for example, suppliers, lenders, customers, shareholders holding a complex blend of senior, junior, short- and long-term implicit and explicit claims against the firm.[60] Its advantage is stability, however, this feature can turn into inflexibility, as seen in Japan since the early 1990s.[61]

III.
Implications of Legal Traditions and Rule of Law

Recent corporate governance literature, suggests that the most important cause of the differences in various systems is the existence of distinct legal traditions (i.e. common or civil law traditions) across nations, since the legal system of a country molds investors' rights and protections insofar as their interactions with companies is concerned.[62] Moreover, this literature states that the rule of law (among other things, most importantly, the extent to which contracts are legally enforced) also greatly influences the effectiveness of corporate governance.[63]

This literature claims that a critical component in the examination of the principles of corporate governance, and the very concept of the corporation itself lies in the system of law

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Mariko Sakakibara, Can Japan Compete? 18-21, 69-99, 150-52 (2000). Following the 1997-1998 financial crises, the same is true in the Republic of Korea and other Pacific Basin nations. *Id.* at 1-7, 69-99, 162-190.

60. Chicara Higashi & G. Peter Lauter, The Internationalization of the Japanese Economy 338-348 (1990); Michael E. Porter, Hirotaka Takeuchi & Mariko Sakakibara, Can Japan Compete? 18-21, 69-99, 150-52 (1990); Gerald Meier, The International Environment of Business: Competition and Governance in the Global Economy 272-273 (1998).

61. Michael E. Porter, Hirotaka Takeuchi & Mariko Sakakibara, Can Japan Compete? 1-17 (2000).

62. *See, e.g.*, René David & John E.C. Brierley, Major Legal Systems in the World Today (1985); Rafael La Porta et al., *Law and Finance*, 106 J. Pol. Econ. 1113 (1998); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. Fin. 1131 (1997); Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. Fin. 3 (2000); Ross Levine, *The Legal Environment, Banks, and Long-Run Economic Growth*, 30 J. Money, Credit & Bank. 596 (1998).

63. William R. Emmons & Frank Schmid, *Corporate Governance and Corporate Performance*, *in* Corporate Governance and Globalization (Stephen S. Cohen & Gavin Boyd eds., 2000); Rafael La Porta, et. al, *Law and Finance*, 106 J. Pol. Econ. 1113 (1998).

that a particular country adheres to.[64] Although there are, of course, a variety of legal systems or families of laws, the two major systems that are accepted in the major trading and industrialized nations today are the Romano-Germanic family (commonly referred to as the Civil Law system) and the Common Law Family (commonly referred to as the Common Law system).[65] Although other religious and/or quasi-legal traditions are presently used in many countries, they are primarily of "rule-based systems of law - such as Hindu law, Canon law, Jewish law, and Muslim law,"[66] for the purpose of this study they are not considered as their importance in understanding the relationship between corporate governance and national investor protection is thought to be less important.[67]

Civil Law is based on written legal codes, with disputes being settled by reference to such written legal code.[68] Commentators, or legal scholars write treatises on the law, and the codes are thus expanded upon by scholars. The Civil Law system attempts to create a unified legal system.[69] In the Common Law system, scholarly writing is often merely interesting and used to educate, though it may be use to persuade a judge in a specific case.[70] It often is not used in this way.[71] Judge-made law, based on previous judicial decisions, called precedent, characterizes the Common Law.[72] Of course today there

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64. *Id.*

65. William R. Emmons & Frank Schmid, *Corporate Governance and Corporate Performance, in* CORPORATE GOVERNANCE AND GLOBALIZATION (Stephen S. Cohen & Gavin Boyd eds., 2000); Rafael La Porta, et. al, *Law and Finance,* 106 J. POL. ECON. 1113 (1998). *See also* RENÉ DAVID & JOHN E.C. BRIERLEY, MAJOR LEGAL SYSTEMS IN THE WORLD TODAY 1-33 (1985).

66. William R. Emmons & Frank Schmid, *Corporate Governance and Corporate Performance, in* CORPORATE GOVERNANCE AND GLOBALIZATION 66-67 (Stephen S. Cohen & Gavin Boyd eds., 2000);

67. Rafael La Porta, et. al, *Law and Finance,* 106 J. POL. ECON. 1113 (1998).

68. JOHN HENRY MERRYMAN, THE CIVIL LAW TRADITION: AN INTRODUCTION TO THE LEGAL SYSTEMS OF WESTERN EUROPE AND LATIN AMERICA (2d ed. 1990).

69. *See* B. FRED. THE GERMAN CIVIL CODE (1994); M. PELTZER, J. DOYLE & E.A. VOIGHT, GERMAN COMMERCIAL CODE/HANDELSGESETZBUCH (4th ed. 2000); ANDREW WEST, THE FRENCH LEGAL SYSTEM: AN INTRODUCTION (1992).

70. OLIVER WENDELL HOLMES, THE COMMON LAW (1991); KARL N. LLEWELLYN, THE COMMON LAW TRADITION: DECIDING APPEALS (1996).

71. *Id.*

72. *Id.*

are many statutes, but the judges always interpret and give life to the law, and judge-made law, unless overturned by a higher court, or the same court in a later case, is the law of the land.[73] On the other hand, a court decision in a Civil Law Jurisdiction is only dispositive of the case at hand and has no precedential effect.[74]

The Civil legal tradition's origins are found in old Roman law and therefore precedes Common Law tradition.[75] As mentioned, Civil Law "utilizes comprehensive codes and statutes as the principal method to systematize its legal principles. The system tends to rely on legal scholars to interpret the code and draft new interpretations and rules rather than building on judicial precedents alone."[76]

Countries where the Common Law tradition is primarily found are the United States, United Kingdom, and Canada (and other English speaking nations and/or nations whose post-World War II progress was strongly impacted by other English-speaking nations).[77] "The Civil Law (or Roman-Germanic tradition) is [primarily] found in continental Europe and other nations that where heavily influenced by continental

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73. *Id.*

74. John Henry Merryman, *Civil Law Tradition*, 35 AM. J. COMP. L. 438-441 (1987); JOHN HENRY MERRYMAN, THE CIVIL LAW TRADITION: AN INTRODUCTION TO THE LEGAL SYSTEMS OF WESTERN EUROPE AND LATIN AMERICA (2d ed. 1990). *See also* SHELDON AMOS, THE HISTORY AND PRINCIPALS OF THE CIVIL LAW OF ROME (1987).

75. William R. Emmons & Frank Schmid, *Corporate Governance and Corporate Performance, in* CORPORATE GOVERNANCE AND GLOBALIZATION 69 (Stephen S. Cohen & Gavin Boyd eds., 2000); *See also* SHELDON AMOS, THE HISTORY AND PRINCIPALS OF THE CIVIL LAW OF ROME (1987); JOHN HENRY MERRYMAN, THE CIVIL LAW TRADITION: AN INTRODUCTION TO THE LEGAL SYSTEMS OF WESTERN EUROPE AND LATIN AMERICA (2d ed. 1990).

76. *Id.*; Rafael La Porta, et. al, *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

77. The common-law group includes all the English–speaking members of the OECD as well as former British colonies and protectorates. A sampling of these nations would include, among others, Australia, Ireland, New Zealand, Hong Kong, India, Israel, Pakistan, Kenya, Thailand and South Africa. William R. Emmons & Frank Schmid, *Corporate Governance and Corporate Performance, in* CORPORATE GOVERNANCE AND GLOBALIZATION (Stephen S. Cohen & Gavin Boyd eds., 2000);

Europeans,"[78] such as Latin America. However, there are three main generally accepted subdivisions within the Civil Law tradition: the German,[79] the French,[80] and the Scandinavian[81] Civil Law tradition.[82] It should be noted that the English and French legal systems are used in the largest number of nations.[83] While the German and Scandinavian legal systems are not as broadly used globally as their colonial power was not only comparatively smaller but also geographically more restrictive than English and the French.[84] Given current global trading and investment patterns it is not unexpected that Russia and many nations of Central and Eastern Europe (some of whom have now joined the European Union) have developed legal and financial systems alone the lines of the German system, however, what is rather surprising is to see the same pattern emerging in China.[85]

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78. William R. Emmons & Frank Schmid, *Corporate Governance and Corporate Performance, in* CORPORATE GOVERNANCE AND GLOBALIZATION 67 (Stephen S. Cohen & Gavin Boyd eds., 2000);

79. The German Commercial Code, created in 1987, includes, asides from Germany, a sampling of the following nations, among others: Austria, Japan, South Korea , Switzerland, Netherlands, and Taiwan. William R. Emmons & Frank Schmid, *Corporate Governance and Corporate Performance, in* CORPORATE GOVERNANCE AND GLOBALIZATION 68-69 (Stephen S. Cohen & Gavin Boyd eds., 2000).

80. The French Commercial Code was created, in 1807, during the Napoleonic era. It's usage in other countries was primarily due to military conquests (at least at first). Aside from France, a sampling of these nations would include, among others, Belgium, Greece, Italy, Mexico, Spain, Turkey, Argentina, Brazil, Chile, Indonesia, Jordan, Egypt, Philippines, and Venezuela. William R. Emmons & Frank Schmid, *Corporate Governance and Corporate Performance, in* CORPORATE GOVERNANCE AND GLOBALIZATION 68-70 (Stephen S. Cohen & Gavin Boyd eds., 2000).

81. These nations include Denmark, Finland, Sweden and Norway. William R. Emmons & Frank Schmid, *Corporate Governance and Corporate Performance, in* CORPORATE GOVERNANCE AND GLOBALIZATION 68 (Stephen S. Cohen & Gavin Boyd eds., 2000).

82. Rafael La Porta, et. al, *Law and Finance,* 106 J. POL. ECON. 1113 (1998); William R. Emmons & Frank Schmid, *Corporate Governance and Corporate Performance, in* CORPORATE GOVERNANCE AND GLOBALIZATION (Stephen S. Cohen & Gavin Boyd eds., 2000).

83. William R. Emmons & Frank Schmid, *Corporate Governance and Corporate Performance, in* CORPORATE GOVERNANCE AND GLOBALIZATION 67 (Stephen S. Cohen & Gavin Boyd eds., 2000).

84. *Id.*

85. *Id.*

The reason why legal traditions are so crucial is that "they are systematically related to . . . the types of legal rights and protection provided to investors"[86] i.e. creditor rights and shareholder rights, respectively.[87] This is vital as these rights and protections shape the manner in which not only corporate financing is conducted, but impacts its variety, instruments offered, and availability.[88] This reverberates and impacts the manner in which a countries financial markets develops over time as it molds market accesses of investor participants (i.e. individuals, banks, or non-bank financial institutions, pension funds, mutual funds, etc) and their level of activity in the marketplace.[89] Furthermore, "legal rights of shareholders and creditors, [for example,] to receive cash payments and[/or] to participation in . . . [firm] decision-making . . . are necessary but not sufficient conditions for effective corporate governance. As such, a climate of respect for the rule of law is also needed."[90] In order to show that different types of corporate governance systems create variances in financial markets one could adopt the premise that the more superior a nation is on shareholder rights, creditor rights and the rule of law, the more financial stable its financial markets are, which, in turn, positively influences corporate efficiency in terms of access and use of financial markets.[91] There are many studies that have proven the relationships between relative importance of debt and equity markets based on Common-law versus Civil-Law traditions for corporate governance systems.[92] The

86. *Id.* at 70; Rafael La Porta, et. al, *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

87. Rafael La Porta, et. al, *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

88. *Id.*

89. *Id.*

90. William R. Emmons & Frank Schmid, *Corporate Governance and Corporate Performance*, *in* CORPORATE GOVERNANCE AND GLOBALIZATION 74 (Stephen S. Cohen & Gavin Boyd eds., 2000); Rafael La Porta, et. al, *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

91. William R. Emmons & Frank Schmid, *Corporate Governance and Corporate Performance*, *in* CORPORATE GOVERNANCE AND GLOBALIZATION (Stephen S. Cohen & Gavin Boyd eds., 2000).

92. Rafael La Porta, et. al, *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Andrei Shleifer & Robert Vishny, *The Takeover Wave of the 1980s*, 249 SCIENCE 745, 745-749 (1990); OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 37-54 (1995); Raghu Rajan & Julie Wulf, *The Flattening Firm* (University of Chicago, Working Paper, 2002); CORPORATE GOVERNANCE: IM-

overall picture that emerges from these studies is that Common Law nations have much larger markets for outside equity, and for some nations, also for corporate bonds[93] and that for most firms in civil-law countries public equity and bond markets are relatively unimportant.[94] In Civil Law nations, most external financing done by firms is in the form of banks loans.[95] The smaller, more underdeveloped public equity and bonds markets in nations under the Civil Law tradition imply that the firms in these nations are restricted to "insider (or "near-insider") financing consisting of owner-contributed funds, retained earnings or bank debt."[96] The negative implications of these restrictions i.e. lack of access to external financing, are many. For instance, it would be hard for new entrants in the marketplace and result in smaller quantity of firms which in turn would lead to less competition and market growth. Moreover, the firms that are in operation would tend to remain small in size and be more financially frail as any aggressive business venture would have to be financed internally and thus determined by business cycles. Furthermore, this could lead to a depletion of retrained earnings. The alternative is to engage in bank financing that might bring about undue bank influence over firms and could result in ownerships being less diversified.[97]

IV.
Evaluation Of U.S. Corporate Governance Post-1980

The standard literature on American corporate governance focuses on a heuristic model where managers of large public corporations work to maximize shareholder returns.[98]

PROVING COMPETITIVENESS AND ACCESS TO CAPITAL MARKETS, A REPORT TO THE OECD BY THE BUSINESS SECTOR ADVISORY GROUP ON CORPORATE GOVERNANCE (Organization for Economic Co-operation and Development ed., 1998).

93. This does not imply that banks are not important in Common Law nations.

94. William R. Emmons & Frank Schmid, *Corporate Governance and Corporate Performance, in* CORPORATE GOVERNANCE AND GLOBALIZATION 76-82 (Stephen S. Cohen & Gavin Boyd eds., 2000).

95. *Id.*

96. *Id.*

97. *Id.*

98. *Anglo Saxon Model: A Critical View,* BANQUE PARIBAS CONJONCTURE, Oct. 2005, 16-29, *available at* http://economic-research.bnpparibas.com/ap-

This paradigm, which is viewed as the primary cause for the current problems in American corporate behavior, is a relatively new phenomenon.[99] The corporate governance in existence, prior to 1980 had managers of large public U.S. corporations attempt to balance the interests of all stakeholders rather than maximizing shareholders wealth.[100] This period was characterized by limited external oversight. There was little in the way board oversight, limited proxy fights and very little in the way of shareholder litigation.[101]

Manager's performance requirements were based on the traditional long-term performance plans based on sales growth and growth in earnings per share.[102] There was little direct linkage between management performance ownership and their compensation in the form of stock and options.[103]

In the 1980s, takeovers (friendly and hostile) radically changed the landscape of the U.S. economy.[104] Approximately $1.3 trillion value of assets turned over during the 10-

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plis/www/RechEco.nsf/ConjonctureByDateEN/1D7F2D42CE54277CC1257 0A7004F8E6A/$File/C0510_A2.pdf?OpenElement; Merton H. Miller, *Is American Corporate Governance Fatally Flawed*, *in* STUDIES IN INTERNATIONAL CORPORATE FINANCE AND GOVERNANCE SYSTEMS: A COMPARISON OF THE U.S., JAPAN AND EUROPE 38-44 (Donald Chew, ed., 1997).

99. *Anglo Saxon Model: A Critical View*, BANQUE PARIBAS CONJONCTURE, Oct. 2005, 16-29, *available at* http://economic-research.bnpparibas.com/applis/www/RechEco.nsf/ConjonctureByDateEN/1D7F2D42CE54277CC1257 0A7004F8E6A/$File/C0510_A2.pdf?OpenElement; Merton H. Miller, *Is American Corporate Governance Fatally Flawed*, *in* STUDIES IN INTERNATIONAL CORPORATE FINANCE AND GOVERNANCE SYSTEMS: A COMPARISON OF THE U.S., JAPAN AND EUROPE 38-44 (Donald Chew, ed., 1997); Bengt Holmstrom & Steven Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* (European Corporate Governance Institute, Finance Working Paper No.23/2003, 2003).

100. Bengt Holmstrom & Steven Kaplan, *Corporate Governance and Takeovers in the U.S.: Making Sense of the '80s and '90s*, 15 J. ECON. PERSPECTIVES 121, 121-144 (2001); Steven Kaplan, *The Evolution of U.S. Corporate Governance: We Are All Henry Kravis Now* 13 (NBER, Working Paper, 1997), *available at* http://www.isc-capital.com/downloads/lbo1297.pdf; GORDON DONALDSON & JAY LORSCH, DECISION MAKING AT THE TOP (1983).

101. Steven Kaplan, *The Evolution of U.S. Corporate Governance: We Are All Henry Kravis Now* 13 (NBER, Working Paper, 1997), *available at* http://www.isc-capital.com/downloads/lbo1297.pdf.

102. *Id.*

103. *Id.*

104. Andrei Shleifer & Robert Vishny, *The Takeover Wave of the 1980s*, 249 SCIENCE 745 (1990).

year period between 1980-1989. During the same time period, of the U.S. Fortune 500[105] approximately 28% (or 143) had been acquired and although many tended to be friendly, many where also hostile takeovers.[106] Thus the 1980s saw the emergence of the corporate raider and hostile takeovers.[107] Over 40 percent of all major U.S. corporations received a takeover offer in the 1980s and many suspecting takeovers, responded with pre-emptive internal restructurings that were designed to make them less attractive targets.[108]

"[Between] . . . 1984-1990, more than $500 billion of equity was retired (net of new equity issuances), as many firms repurchased their own shares, borrowed to finance takeovers, or were taken private in leveraged buyouts (LBOs). As a result, corporate leverage ratios increased significantly."[109] Leveraged buyouts "were extreme in this respect, with debt levels typically exceeding 80% of total capital."[110]

In the 1990s, as merger activity began to fall, other corporate governance mechanisms began to play a larger role, particularly executive stock options and the greater involvement of boards of directors and shareholders.[111] Governing boards substantially increased the use of stock option plans that allowed managers to share in the value created by restructuring their own companies.[112] As long as investors were satisfied that managers would take into account shareholder value

105. 500 of the largest industrial corporations in the U.S.

106. Andrei Shleifer & Robert Vishny, *The Takeover Wave of the 1980s*, 249 SCIENCE 745 (1990).

107. *Id.* at 745-49.

108. Mark Mitchell & Harold Mulherin, *The Impact of Industry Shocks on Takeover and Restructuring Activity*, 41 J. FIN. ECON. 193, 193-229 (1996).

109. Bengt Holmstrom & Steven Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 7 (European Corporate Governance Institute, Finance Working Paper No.23/2003, 2003).

110. Bengt Holmstrom & Steven Kaplan, *Corporate Governance and Takeovers in the U.S.: Making Sense of the '80s and '90s*, 15 J. ECON. PERSPECTIVES 121 (2001).

111. Andrei Shleifer & Robert Vishny, *The Takeover Wave of the 1980s*, 249 SCIENCE 745-749 (1990); Bengt Holmstrom & Steven Kaplan, *Corporate Governance and Takeovers in the U.S.: Making Sense of the '80s and '90s*, 15 J. ECON. PERSPECTIVES 121, 124-25 (2001).

112. Bengt Holmstrom & Steven Kaplan, *Corporate Governance and Takeovers in the U.S.: Making Sense of the '80s and '90s*, 15 J. ECON. PERSPECTIVES 121, 129-139 (2001).

there was less of a need for high leverage[113]. Deals could now be financed by stocks.[114] The merger activity of the 1990s was quite different then the merger activity of the 1980s.[115] While the latter was motivated by a perceived view that mangers were ineffective or inefficient, the transactions of the 1990s, by contrast, had more of a "asset creation" effect in which assets were reconfigured to take advantage of growth opportunities in new technologies and markets.[116] This new wave of mergers was accompanied by increased use of equity rather than debt in funding the deals of the 1990s.[117]

The role of capital market forces has also increased with this wave of mergers.[118] During the 1990s most of the restructuring of large firms and the wave of the high tech sector growth was funded by venture capitalists.[119] The presumption made in the business literature is that with the events of the 1990s, corporate manager's "scope and independence in their

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.*

118. Paul Gompers & Josh Lerner, *The Venture Capital Revolution*, 15 J. ECON. PERSPECTIVES 145, 145-168 (2001).

119. Raghu Rajan & Julie Wulf, *The Flattening Firm* (University of Chicago, Working Paper, 2002); Paul Gompers & Josh Lerner, *The Venture Capital Revolution*, 15 J. ECON. PERSPECTIVES 145, 145-168 (2001). Gomper and Lerner measured the amount of money that was pledged to U.S. venture capital funds annually from 1969 to 2000 (in billions of 1999 dollars). They found that in 1969 it was $0.45 billion, in 1979 $0.64 billion, in 1989 $4.1 billion, in 1999 $36 billion, in 2000 $68.6 billion. Moreover, they measured the investors average annual rate of return (ROR) in U.S. venture capital funds from 1974 to 1999. They found that in 1975 it was 14.5%, in 1985: 1.3%, in 1990: 0.3%, in 1995: 50%, and in 1999: 144%. They also looked at venture capital fund-raising by independent venture partnerships from 1979 to 2000 and found the following in terms number of funds and size in 1999 $billion: in 1979 27 firms ($0.53 bill), in 1983: 147 firms ($6.01 bill), in 1987: 112 firms ($5.93 bill), in 1991: 34 firms ($1.69 bill), in 1995: 84 firms ($4.60 bill), in 1999: 204 firms ($37.46 bill), and in 2000: 228 funds ($67.7 bill). Lastly they measured the number of venture-backed IPOs and as a portion of the total IPOs between 1978 and 1999 and measured the same in dollar volume of venture-backed IPOs and as a portion of the total IPOs. They following where the results of the study:

decision-making has narrowed."[120] This did not mean that they could not reallocate "vast amounts . . . [of economic] resources through internal capital and labor markets."[121]

We now focus more specifically on changes in the three key elements of the U.S. corporate governance system: executive compensation, character of shareholders, and selection and role of boards of directors.

V.
CHANGES IN EXECUTIVE COMPENSATION

Over the last two decades, the total pay of top U.S. executives rose dramatically, this was particularly true for option-based compensation. Hall and Liebman's 1998 report concluded that during 1980 to 1994, the average CEO compensation of big U.S. firms increased three-fold (in real terms).[122] Moreover, they found that the average CEO option grant[123] increased roughly seven-fold on a yearly bases. They concluded that these large increases in equity-based CEO compensation were responsible for more than approximately 50% of total CEO compensation (in 1994). This was an approximate 30% rise from 1980.[124] Another study in 2002 (Hall and Murphy 2002[125]) confirmed that equity-based CEO compensa-

Year	Number of Venture-backed IPOs (dollar volume in 1999 $ billions)	Total Number of IPOs (dollar volume in 1999 $ billions)
1980	24 ($1.2 bill)	256 ($2.7 bill)
1985	37 ($1.25 bill)	500 ($15.8 bill)
1990	44 ($1.67 bill)	275 ($5.75 bill)
1995	206 ($7.5 bill)	562 ($42 bill)
1999	268 ($24.2 bill)	475 ($65.8 bill)

120. Bengt Holmstrom & Steven Kaplan, *Corporate Governance and Takeovers in the U.S.: Making Sense of the '80s and '90s*, 15 J. ECON. PERSPECTIVES 121, 136-37 (2001).

121. *Id.*

122. Brian Hall & Jeffrey Liebman, *Are CEOs Really Paid like Bureaucrats?*, 112 Q. J. ECON. 653 (1998).

123. Valued at issuance.

124. Brian Hall & Jeffrey Liebman, *Are CEOs Really Paid like Bureaucrats?*, 112 Q. J. ECON. 648, 653 (1998).

125. Brian Hall & Kevin Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3 (2002).

tion continued to increase well into 2001. They found that between 1994 to 2001 option-based CEO compensation rose at a faster pace than even CEO salary, which had doubled during that same time-period. Table 1, 2, 3 and 4 show the results of the Hall and Liebman 1998 and the Hall and Murphy 2002 reports.[126]

TABLE 1
CEO STATISTICS[127]

Variable	Mean	Median	Minimum	Maximum
Age of CEO	57.6	58	36	82
Years as CEO	8.4	6.0	1.0	38.0
Years employed by company	22.0	22.0	1.0	59.0
Percent of Firm Stock Owned by CEO	2.15%	0.14%	0%	53%
Salary and Bonus	$1,292,290	$1,050,000	$52,000	$16,000,000
Value of Option grants	$1,213,180	$324,989	$0	$28,849,350
Value of Restricted Stock grants	$201,736	$0	$0	$9,737,770
Other compensation	$319,014	$69,000	$0	$11,154,000

TABLE 2
CEO COMPENSATION[128]

Year	Salary & Bonus		Value Of Stocks Option Grants		Direct Compensation		Total Wealth Increase	
	mean	*median*	*mean*	*median*	*mean*	*median*	*mean*	*median*
1980	654,935	566,541	155,037	0	809,973	622,777	5,493,312	1,025,342
1985	830,365	705,190	431,333	6,257	1,261,698	853,985	8,122,815	2,044,776
1990	1,005,860	857,791	751,477	71,646	1,757,336	1,098,947	907,567	483,799
1994	1,292,290	1,050,000	1,213,180	324,989	2,505,469	1,472,202	9,168,990	1,046,897
% change 1980-1994	97.3	85.3	682.5	NA	209.3	136.4	—	—

126. *Id.*.

127. Brian Hall & Jeffrey Liebman, *Are CEOs Really Paid like Bureaucrats?*, 112 Q. J. ECON. 648 (1998).

128. *Id.* at 648-50. Annual Sample sizes vary from 365 to 432. Direct compensation is salary and bonus plus value of stock option grants. Total wealth increase is the increase in the value of the CEO's holdings of firm stock and stock options plus direct compensation.

TABLE 3
COMPENSATION GROWTH – CEOs RELATIVE TO OTHER WORKERS (1994 DOLLARS)[129]

Group	1982	1994	% change, 1982-1994	Annualized % Change 1982-1994
CEO Direct Compensation (Mean values)	$911,011	$2,505,469	175.0	8.8
CEO Direct Compensation (Median values)	$669,588	$1,472,202	119.9	6.8
All Workers	$30,400	$32,600	7.2	0.6

TABLE 4
CEO PAY AND RISK ADJUSTED PAY IN S&P 500 INDUSTRIALS, 1992-1998[130]

Year	Median CEO pay ($000)	Salary	Bonus	Stockbased	Other
1992	$1,986	41%	22%	30%	7%
1993	$2,375	36%	21%	34%	8%
1994	$2,714	32%	24%	36%	8%
1995	$3,221	27%	23%	42%	8%
1996	$3,754	26%	21%	46%	7%
1997	$4,208	23%	21%	48%	7%
1998	$5,129	22%	18%	53%	7%

129. *Id.* at 650. CEO Direct Compensation is salary and bonus plus value of stock option grants. All Workers are total compensation from the employment cost index (Bureau of Labor Statistics). Compensation levels for all workers are calculated by dividing NIPA total compensation of all employees by the total number of employees in the economy

130. Brian Hall & Kevin Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3 (2002). Median pay levels (in 1998-constant dollars) based on ExecuComp data for S&P 500 CEOs (financial firms and utilities excluded). Total compensation (in columns) defined as the sum of salaries, bonuses, benefits, stock options (valued on date of grant using the Black-Scholes formula), stock options, and other compensation.

TABLE 5
PERCENT AND REAL DOLLAR VALUE OF MANAGERIAL EQUITY OWNERSHIP IN 1935 AND 1995 AND MEAN MANAGERIAL EQUITY OWNERSHIP PERCENT BY INDUSTRY GROUPING IN 1935 AND 1995[131]

	1935		1995	
	%	$ million	%	$ million
Full Sample of Firms	1,419 firms		4,202 firms	
Median	6.5%	3.0	14.4%	16.2
Mean	12.9%	17.9	21.1%	73.0
NYSE Sample	651 firms		1,464 firms	
Median	3.7%	5.4	4.7%	30.7
Mean	8.6%	32.0	12.2%	131.2
Mean Managerial Equity Ownership by Industry (%)	1935		1995	
Agriculture, Mines, Construct.	10.8		19.1	
Food, Textiles, Clothes	17.4		26.3	
Lumber, Paper, Printing	20.5		23.4	
Chemical, Oil, Plastic	11.8		19.6	
Stone, Clay, Metals	14.7		20.1	
Machines, Elect. Equipment	16.1		20.7	
Auto, Transport Equip.	12.9		23.4	
Railroads, Other Transport	4.5		25.0	
Communications	0.9		21.7	
Public Utilities	1.0		9.9	
Retail/Wholesale Trade	25.9		26.8	
Finance, Insurance, Real Estate, Holding Cos.	8.4		17.4	
Services	14.4		26.5	

131. Cliff Holderness, Randall Kroszner & Dennis Sheehan, *Were the Good Old That Good? Changes in Managerial Stock Ownership Since the Great Depression*, 54 J. FIN. 435, 448-450 (1999). Comparison of the mean and median percentages and real dollar values of the total equity ownership of officers and directors for exchange-listed firms in 1935 and 1995. The percentage ownership is the sum of the common shares held by officers and directors divided by the number of common shares outstanding. The dollar value is the end-of-year stock price times the number of shares held and is in millions of 1995 dollars. Comparison by industry grouping of mean percentage managerial ownership, industry groupings are based on two digit SIC codes.

The authors argue that the effect of this dramatic increase in CEO equity-based compensation is that it strengthened the linkage of CEO pay-to-performance substantially.[132] Table 5 conveys the summary and results of the Holderness, Kroszner and Sheehan 1999 study. While many in the literature would argue that tying compensation to both current and future performance (options) would improve the ability of the market to monitor CEO performance, the scandals of over the last few years and shrinking stock market performance has resulted in sharp criticism of the CEO pay-to-performance schemes that allow for the large and un-observed transfers of "shareholder wealth" to CEOs with no visible advantageous of such managerial inducements.[133]

Studies such as, Holmstrom and Kaplan's[134] however, reject such cynicism despite recent scandals. They argue instead that the shift to the equity market for managerial compensation actually benefits the shareholders more than ever before because now managerial personal interests are similar to that of shareholders.[135] Their argument rests on the premise that with an ever-larger share of compensation in the form of stocks and/or options, CEO's will become more elastic with respect to the expected 'value-increasing' transactions.[136] Holmstrom and Kaplan cite Core and Larcker,[137] who find that option grants or increases in equity ownership are related to improvements in stock and accounting performance.[138]

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132. *Id.*

133. Lucian Bebchuk, Jesse Fried & David Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation,* 69 U. CHI. L. REV. 751 (2002).

134. Bengt Holmstrom & Steven Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 17 (European Corporate Governance Institute, Finance Working Paper No.23/2003, 2003).

135. *Id.*

136. *Id.*

137. John Core & David Larcker, *Performance Consequences of Mandatory Increases in Executive Stock Ownership,* 64 J. FIN. ECON. 317 (2002).

138. Some people have cited the 1997 decision of the Business Roundtable to change its position on business objectives to read "the paramount duty of management and the board is to the shareholder and not to . . . other stakeholders" as a further reflection of the importance of shareholder wealth maximization to CEO's. In the alternative, one can argue that since CEOs are also stockholders and stakeholders this change in objectives is only self-serving. Steven Kaplan, *The Evolution of U.S. Corporate Governance: We Are All Henry Kravis Now* 13 (NBER, Working Paper, 1997), *available at* http://

Kaplan[139] in a 1989 study found that the "CEOs of companies taken private in leveraged buy-outs (LBOs) increased their ownership stake from an average of 1.4% before the LBO to 6.4% after. The study also found that management teams as a whole typically obtained 10% to 20% of the post-buyout equity."[140] Holland and Haas,[141] in a recent Harvard Business Review article, report that "higher levels of managerial equity ownership are still typical in today's buyout transactions."[142]

In cases where the LBO involves non-public firms, the equity and options held by those CEOs are characteristically "illiquid."[143] It is only when the company has gone public or has been sold to another company that CEOs can get an instant return.[144] This means that CEOs cannot simply trade their performance results on the open market.[145] Unfortunately, even though the greater reliance on the use of stock-based compensation may have beneficial consequences on motivation, they have come at a significant price i.e. to the detriment of the American corporate governance system.[146] As we have seen in the very public cases of Global Crossing and WorldCom, as CEO's "stock and option ownership have increased, so has the incentive to manage and manipulate accounting numbers in order to inflate stock market values and sell shares at those inflated values."[147] This literature would

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www.isc-capital.com/downloads/lbo1297.pdf. *See also* The Business Roundtable, Statement on Corporate Governance (Sept., 1997); John Byrne, *CEOs Catch Up With Shareholder Activist*, BUS. WK., Sept. 22, 1997, at 36.

139. Steven Kaplan, *The Effects of Management Buyouts on Operations and Value*, 24 J. FIN. ECON. 217 (1989).

140. Bengt Holmstrom & Steven Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 12 (European Corporate Governance Institute, Finance Working Paper No.23/2003, 2003).

141. P. Rogers, T. Holland & D. Haas, *Value Acceleration: Lessons from Private-Equity Masters*, 80 HARV. BUS. REV. 94 (2002).

142. Bengt Holmstrom & Steven Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 12 (European Corporate Governance Institute, Finance Working Paper No.23/2003, 2003).

143. *Id.* at 13-15.

144. *Id.*

145. *Id.*

146. *Id*; Lucian Bebchuk, Jesse Fried & David Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

147. Bengt Holmstrom & Steven Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 14 (European Corporate Governance

suggest that the timing and liquidity of options and the liquidity of stock compensation schemes should become the focus of future reforms of CEO compensation. In 2001, for example, the ten most highly rewarded CEOs in the S&P 500 were granted option packages with an estimated average value (at time of grant) of $170 million per person.[148] During the same period "the median value of total compensation for CEOs of S&P 500 companies was about $7 million."[149] Is that too much or too little?

VI.
CHANGES IN THE CHARACTER OF SHAREHOLDERS

Since 1980 there has been a substantial increase in the share of the overall stock market owned by large institutional investors.[150] This has been specifically true for financial institutional investor (back and non-bank).[151] Between 1980 and 1996, large institutional investors ("a category including all managers with greater than $100 million under discretionary control")[152] increased their share of ownership of U.S. corporations from "less than 30% to more than 50%." On the other hand, studies[153] show that individual ownership fell from "70%

Institute, Finance Working Paper No.23/2003, 2003). For more details see Jeremy Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q. J. ECON. 655, 660-669 (1989).

148. Bengt Holmstrom & Steven Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 15 (European Corporate Governance Institute, Finance Working Paper No.23/2003, 2003).

149. *Id.*

150. Paul A. Gompers & Andrew Metric, *Institutional Investors and Equity Prices*, 116 Q. J. ECON. 229, 239 (2001).

151. *Id.*

152. Paul A. Gompers & Andrew Metric, *Institutional Investors and Equity Prices*, 116 Q. J. ECON. 229, 229 (2001). Tables 7 and 8 show Gompers and Metrick's research results.

153. James M. Poterba & Andrew A. Samwick, *Stock Ownership Patterns, Stock Market Fluctuations, and Consumption*, *in* 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 295, 313 (William C. Brainard & George L. Perry eds., 1995); Paul A. Gompers & Andrew Metric, *Institutional Investors and Equity Prices*, 116 Q. J. ECON. 229 (2001). Table 6 shows Poterba and Samwick 1995 survey results on stock ownership shares. Household category includes ownership by non-profit institutions. Pension funds include private and government plans. Mutual funds include closed-end as well as open-end investment companies. Entries are based on the total amount of corporate stock held by

in 1970 to 60% in 1980 and to 48% in 1994."[154] Moreover, Huson, Parrino, and Starks[155] also show significant growth in the percentage share of institution ownership between 1971 and 1994.[156]

TABLE 6
STOCK OWNERSHIP SHARES, UNADJUSTED FLOW OF FUNDS, 1952-94 (IN % TERMS)[157]

Year	Households	Pension funds	Mutual funds	Foreign	Insurance companies
1952	89.7	1.1	3.1	2.2	3.4
1962	84.7	4.8	4.8	2.2	3.1
1972	64.1	11.5	5.1	3.5	4.3
1982	56.1	21.3	3.3	4.7	5.7
1992	51.4	25.8	8.7	5.5	4.0
1994	47.7	25.7	13.6	5.4	4.2

TABLE 7
STOCK OWNERSHIP[158]

Year	First	First 10	First 100	Total Institution
1980	1.25%	5%	17.5%	24.4%
1985	0.9%	5.1%	21.9%	35%
1990	1.9%	8.1%	28.1%	44.3%
1995	2.5%	10.3%	35.6%	52.5%
1996	3.1%	13.7%	37.5%	52.5%

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mutual funds. Insurance companies include both property and casualty, and life insurance companies

154. Bengt Holmstrom & Steven Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 15 (European Corporate Governance Institute, Finance Working Paper No.23/2003, 2003).

155. M. Huson, Robert Parrino & Laura Starks, *Internal Monitoring Mechanisms and CEO Turnover: A Long-Term Perspective,* 56 J. FIN. 2265 (2001).

156. *See infra* Table 9.

157. James M. Poterba & Andrew A. Samwick, *Stock Ownership Patterns, Stock Market Fluctuations, and Consumption, in* 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 295, 313 (William C. Brainard & George L. Perry eds., 1995).

158. Paul A. Gompers & Andrew Metric, *Institutional Investors and Equity Prices,* 116 Q. J. ECON. 229, 258-60 (2001). Percentage of Market owned by the First, First Ten, and First 100 Institutions ranked by Size and

Year	Small	2 Quantile	3 Quantile	4 Quantile	Large
1980	2.5%	9%	16%	21.5%	29%
1985	5.5%	17.5%	24%	32%	39%
1990	8.5%	27.5%	31.5%	39%	45%
1995	14%	35%	43.5%	47.5%	52%
1996	15%	34.5%	42.5%	48%	53%

TABLE 8
NUMBER OF INSTITUTIONS AND MARKET VALUE OF INSTITUTIONAL HOLDINGS BY MANAGER TYPE[159]

	Banks		Insurance Companies		Mutual Fund Companies		Investment Advisors		Other (University Endowments		Total	
Number of Institutions	*# of firms*	*% of total*	*# of firms*	*% of total*	*# of firms*	*% of total*	*# of firms*	*% of total*	*# of firms*	*% of total*	*# of firms*	
1980	216	41.1%	65	12.4%	47	9.0%	122	23.2%	75	14.3%	525	
1985	224	29.2%	69	9.0%	54	7.0%	332	43.3%	87	11.4%	766	
1990	216	22.1%	73	7.5%	57	5.8%	541	55.4%	89	9.1%	976	
1995	202	15.5%	78	6.0%	96	7.4%	845	65.0%	79	6.1%	1300	
1996	172	13.2%	69	5.3%	90	6.9%	900	69.1%	72	5.5%	1303	
Market Value of Institutional Holdings	*US$ bill*	*% of total*	*US$ bill*	*% of total*	*US$ bill*	*% of total*	*US$ bill*	*% of total*	*US$ bill*	*% of total*	*US$ bill*	*% of Mkt Cap*
1980	172.9	46.1%	44.6	11.9%	30.7	8.2%	79.6	21.2%	47.3	12.7%	375.3	28%
1985	278.6	36.6%	64.6	8.5%	50.8	6.7%	270.6	35.5%	96.8	12.7%	761.5	38%
1990	356.9	30%	92.8	7.8%	75.8	6.4%	522.5	43.9%	143.2	12%	1,191	44%
1995	727.8	22.4%	324.5	10%	719.5	22%	1,174	36%	295	9.1%	3,241	52%
1996	860.9	21.6%	372.8	9.4%	1,008	25%	1,479	37%	259	6.5%	3,981	51%

Institutional Ownership. The sample is all 13F institutions. The percent of local market value of equities held by the first, first ten and first 100 institutions ranked by size as well as the fraction of the market value of public equities by all institutions is presented. Institutional ownership by Size Quantile: the sample is all 13F institutions, size quantiles are determined by the market value of common stock at the end of the previous quarter. Cutoffs for size quantiles are calculated using only NYSE stocks. All US stocks in CRSP are then placed into one of the five quantiles. The average institutional ownership in each size quantile is presented.

159. Paul A. Gompers & Andrew Metric, *Institutional Investors and Equity Prices*, 116 Q. J. ECON. 229, 262-65 (2001). The sample is all 13F institutions.

TABLE 9
INSTITUTIONAL OWNERSHIP[160]
(Percentage of U.S. corporate equity held by U.S. investors that is managed by mutual funds, private pension & government retirement funds, & insurance companies)

Year	Insurance Companies	Private Pension And Government Retirement Funds	Mutual Funds
1971	3.8%	14.6%	5.0%
1975	5.0%	16.0%	3.8%
1980	5.4%	18.5%	3.1%
1985	6.2%	27.0%	5.0%
1990	5.1%	25.8%	6.9%
1994	6.1%	25%	11.9%

Are we better off with this changing character of the stockholders? Will we get better monitoring? In theory, one can argue that the large increase in the shareholdings of institutional investors means that we have greater representation by professional investors. But does that provide unbiased monitoring? In the post-1992 Securities and Exchange Commission (SEC) rules, shareholders can communicate with other shareholders at "any time and in any way as long as they send a copy of the substance of the communication to the SEC afterward."[161] This new rule has reduced the expenditure of managing shareholder actions and blocking management proposals.[162]

It is not surprising to find that this change in the SEC rules combined with the larger role by the institutional investors, shareholder activism has increased in the U.S. since the

160. M. Huson, Robert Parrino & Laura Starks, *Internal Monitoring Mechanisms and CEO Turnover: A Long-Term Perspective*, 56 J. FIN. 2265 (2001).

161. Steven Kaplan, *The Evolution of U.S. Corporate Governance: We Are All Henry Kravis Now* 13 (NBER, Working Paper, 1997), *available at* http://www.isc-capital.com/downloads/lbo1297.pdf.

162. *Id.*

late 1980s.[163] The verification of the impact of such "activism," however, is not clear. Karpoff[164] in a 2001 paper presented a "summary of the results of 20 empirical studies of the effects of formal shareholder proposals and private negotiations with managements where the there was either small or no effects on shareholder value."[165] The results of his study can be found in Table 10. However, Gompers and Metrick,[166] on the other hand, "report[ed] that stock returns over the period 1980-1996 were higher for companies with greater institutional ownership . . ."[167] This may be interpreted to mean that the 'threat' of shareholder action "may indeed be playing a . . . [significant] monitoring role."[168]

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163. *Id.* at 10-12.

164. Jonathan Karpoff, *The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings* 25-27 (University of Washington, Working paper, 1998) (later updated in 2001), *available at* http://scholar.google.com/scholar?hl=EN&lr=&q=cache:S5lgAv0mmuoJ:finance.bi.no/~governance/conference_2001/Karpoff.PDFtheimpact+ofshareholder+activism+on target.

165. Bengt Holmstrom & Steven Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 15 (European Corporate Governance Institute, Finance Working Paper No.23/2003, 2003).

166. Paul A. Gompers & Andrew Metric, *Institutional Investors and Equity Prices,* 116 Q. J. ECON. 229 (2001).

167. Bengt Holmstrom & Steven Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 15 (European Corporate Governance Institute, Finance Working Paper No.23/2003, 2003).

168. *Id.*

TABLE 10
SHAREHOLDER ACTIVISM SUMMARY[169]

Summary Of Empirical Findings Of "The Impact Of Shareholder Activism On Target Companies: A Survey Of Empirical Findings"
"8.a. What we know about shareholder activism:
Many researchers, investors, and managers disagree over the impacts of shareholder activism on target companies. In this paper I summarize the evidence from 20 empirical studies on the two predominate forms of such activism: shareholder proxy resolutions and informal negotiations with target firm managers. The empirical findings imply the following generalizations:
1. Firms attracting activist efforts tend to be large and have high levels of institutional ownership. There is some evidence that these firms also have poor prior stock returns and earnings performance.
2. Activists have been successful at prompting some firms to adopt limited changes in their governance structures. The rate of activists' success in prompting some change in target companies has increased over time.
3. When averaged over all time periods, sponsor types, and proposal types, shareholder proposals have negligible and statistically insignificant short-run effects on share values.
4. Announcements of non-proposal targetings and negotiated settlements between activist shareholders and target companies are associated with an average increase in share values. In some tests, the increase is statistically significant.
5. The average abnormal stock return is non-zero for some subsets of proposal and non-proposal targetings. For example, 1990-91 proposals sponsored by public pension funds at firms that previously had not received proposals, and 1990-93 proposals that were publicized in the financial press before proxy materials were distributed, are associated with share value increases. Proposals by CalPERS in its early period of activism (e.g., 1987-88), in contrast, as associated with share value decreases. These subsample results, however, may reflect data-snooping biases.
6. Shareholder activism is not associated with subsequent changes in earnings, capital expenditures, earnings payout, CEO turnover, CEO compensation, or likelihood of a control change, although it appears to be followed by an unusually high rate of asset divestitures and/or company restructurings.
In short, the empirical literature provides little evidence that shareholder proposals create value, although some negotiation efforts may have. Both proposals and private negotiations have prompted some firms to make small changes in their governance rules. But there is little evidence that either has increased target firms' earnings or had much effect on operations."

169. Jonathan Karpoff, *The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings* 25-27 (University of Washington, Working paper, 1998) (later updated in 2001), *available at* http://scholar.google.com/scholar?hl=EN&lr=&q=cache:S5lgAvOmmuoJ:finance.bi.no/~governance/conference_2001/Karpoff.PDFtheimpact+ofshareholder+activism+on+target.

VII.
CHANGES IN THE SELECTION AND ROLE OF BOARDS OF DIRECTORS

Reforms in the selection of Board members and their role in a public corporation have been undertaken along the lines suggested by Lorsch and MacIver[170] and Hermalin Weisbach.[171] These studies tried to answer the following questions "(1) how do board of directors characteristics such as composition or size related to profitability? (2) how do board characteristics affect the observable actions of the board? and (3) what factors affect the makeup of boards and how they evolve?"[172] What these studies found was that:

> [B]oard composition is not related to corporate performance, while board size is negatively related to corporate performance. Both board composition and size are correlated with the quality of the board's decisions regarding CEO replacement, acquisitions, poison pills, and executive compensation. Finally, boards appear to evolve over time as a function of the bargaining power of the CEO relative to the existing directors. Firm performance, CEO turnover, and changes in ownership structure appear to be important factors affecting changes to boards.[173]

The three key elements of reforms that were undertaken were:

> (a) board selection by a nominating committee rather than the CEO, (b) more equity compensation for directors, and (c) more director control of board meetings through appointment of a lead director or

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170. JAY LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES (1989). A summary of these changes can be found in Ben Hermalin & Michael Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature* 7-26 (FRBNY Economic Policy Review, 2003).

171. Ben Hermalin & Michael Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature* 7-26 (FRBNY Economic Policy Review, 2003).

172. *Id.* at 7.

173. *Id.* at 20.

outside chairman, annual CEO reviews, and regular sessions with outside directors only.[174]

Moreover, CEO turnover has increased in many respects in response to poor performance. Huson, Parrino, and Starks[175] report that there was a significant escalation in not only the appointment of new external (to the company) CEOs but also an escalation in the firing of CEOs during the 1971 to 1994 period. This trend of new external hires and firings of CEOs reached its peak during the 1989 to 1994 period.[176] The report established that during the same time frame (1989-1994), declines in a firms operating income (i.e. key variable used in the Huson, Parrino, and Starks report for measuring performance) was one of the main causes for the CEO turnover (as opposed to what had occurred prior to this time period of 1971-1988).[177]

On the other hand, the past 20 years has also seen a dramatic increase in anti-takeover measures, for example, "poison pills" and staggered boards.[178] Gompers, Ishi, and Metrick[179] report that in the 1990s, firms with lower levels of self-protective anti-shareholder stipulations had significantly higher rates of returns than companies that had a high degree of such defensive weapons.

Notwithstanding all these changes and the evidence favoring participatory Boards, the recent U.S. Senate Report[180] on Enron's Board was specifically disapproving of the lack of independence and oversight by U.S. Boards. It appears that "when a company is [purported to be ill], everyone pays close attention – lenders and investors as well as board members.

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174. Bengt Holmstrom & Steven Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 16 (European Corporate Governance Institute, Finance Working Paper No.23/2003, 2003).

175. M. Huson, Robert Parrino & Laura Starks, *Internal Monitoring Mechanisms and CEO Turnover: A Long-Term Perspective*, 56 J. FIN. 2265 (2001).

176. *Id.*

177. *Id.*

178. Bengt Holmstrom & Steven Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* (European Corporate Governance Institute, Finance Working Paper No.23/2003, 2003).

179. Paul Gompers, Joy Ishi & Andrew Metrick, *Corporate Governance and Equity Prices* 1 (NBER Working Paper 8,449, 2001).

180. *The Role of the Board of Directors in Enron's Collapse: Hearing Before the Permanent Subcomm. of Investigations of the Comm. on Gov. Affairs*, 107th Cong. 107-70 (2002).

But when a company appears to be doing well, as was the case with both Enron and Tyco, investors and the board are likely to be less critical.[181]"

VIII.
CAN FINANCIAL INSTITUTIONAL INVESTORS SAFEGUARD THE RULE OF LAW?

When we noted above that financial institutional investors were becoming more involved in corporate governance, in the 1990s, we need to identify who these financial institutional investors (banks and nonbanks) are. Historically we are most familiar with four brands of financial institutional investors – commercial banks, mutual funds, insurance companies, and pension funds.[182] Although these financial institutions have enough assets to influence large corporations (and it has always been assumed that they do have the influence), the actual fact of the matter is that portfolio rules, anti-networking rules, and other fragmenting rules disable them from systematically taking control blocks and thus limiting their influence. Below we discuss specific legal constraints that limit the influence of four specific financial institutional investors – banks, mutual funds, insurance companies and pension funds – on corporate performance.

A. *Banks*

Banks are traditionally the major holders of financial assets which are available for investment. But under the existing rules of law banks cannot own stock.

1. *The Historical Separation of Banks from Commerce*

The early US history of commercial banking had many cases where manufacturers had corporate charters that in-

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181. Bengt Holmstrom & Steven Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 17 (European Corporate Governance Institute, Finance Working Paper No.23/2003, 2003).

182. In 1990 they had assets, respectively, of $ 3.2 trillion, $ 548 billion, $ 1.8 trillion, and $1.9 trillion. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FLOW OF FUNDS ACCOUNTS: FINANCIAL ASSETS AND LIABILITIES (1990).

cluded the right to open a bank.[183] By the mid-nineteenth century, separation of banking activity from commerce was the norm.[184] The National Bank Act of 1863 gave national banks only limited powers.[185] Control of an industrial company was out of the question.[186] When controversy arose over whether banks could own stocks, the U.S. Supreme Court resolved that question against the banks: the power to own stock was not listed, accordingly it was not granted.[187]

2. *The Glass-Steagall Act*

To get around the direct prohibition on stock dealing, commercial banks began to deal in securities through affiliates. In 1933, Congress reacted to this new threat.[188] The resulting Glass-Steagall Act of 1933 prohibited bank affiliates from owning and dealing in securities, thereby serving commercial banks from investment banks.[189] While prohibitions on commercial banks' underwriting and affiliation with companies dealing in securities are breaking down,[190] prohibition on bank ownership of equity remains intact.[191]

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183. Bray Hammond, *Politics and the Growth of Banking, 1791-1816, in* BANKS AND POLITICS IN AMERICA FROM THE REVOLUTION TO THE CIVIL WAR 149-55 (1957).

184. *Id.*

185. California Bank v. Kennedy, 167 U.S. 362, 366-67 (1897); National Bank Act of Feb. 25, 1863, §§11, 12 U.S.C. §24 (1998). State member banks of the Federal Reserve System were later similarly restricted. Banking Act of 1933 (Glass-Steagall), §5(c), 12 U.S.C. §335 (1998); TAEHO KIM, INTERNATIONAL MONEY AND BANKING 239-41 (1995).

186. *Id.*

187. *Id.*

188. By enacting the Banking Act of 1933 (Glass-Steagall), § 16, 12 U.S.C. § 24 (1998); TAEHO KIM, INTERNATIONAL MONEY AND BANKING 234-38 (1995).

189. *Id.*

190. Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 207, 214-21 (1984) (upholding FRB's authorization of Bank of America to acquire Schwab, a securities dealer); *see also* J. P. Morgan & Co., [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) P87,554 (Jan. 19, 1989) (FRB approves application of commercial bank to establish underwriting affiliate); Bankers Trust New York Corp., 75 Fed. Reserve Bull. 829 (Oct. 30, 1989) (FRB approves application of commercial banks to engage in some brokerage activities); TAEHO KIM, INTERNATIONAL MONEY AND BANKING 234-38 (1995).

191. *Id*; Banking Act of 1933 (Glass-Steagall), § 16, 12 U.S.C. § 24 (1998); TAEHO KIM, INTERNATIONAL MONEY AND BANKING 234-38 (1995).

Bank trust departments are commercial banks' only remaining direct link to the equity market.[192] The legal rules do, however, fragment trust fund investments – no more than 10% of a bank's trust funds may be invested in the stock of any single corporation.[193] This regulation was an outgrowth of the 1968 Patman Report[194] which warned against the growing power of bank trust departments.

3. *The Bank Holding Company Legislation*

The next twist in the banking story came about as an outgrowth of bank attempts to operate from several locations or to chain several banks together. However, many states prohibit banks from branching and prohibit out-of-state banks from operating locally.[195] As a response to these restrictions banks reincorporated themselves, in the 1950s, as holding companies, each owning several separately incorporated banks.[196] The holding company had other regulatory advantages: it was not subject to the same stringent regulation of activities as were the bank subsidiaries – the holding company could own businesses and stock, including control blocks of stocks.[197] In response, Congress enacted the Bank Holding Company Act of 1956,[198] restricting a holding company's activities to those closely related to banking. A bank holding company cannot own more than 5% of the voting stock of any non-

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192. 12 C.F.R. § 9.18(b)(9)(ii) (1990); Bankers Trust New York Corp., 75 Fed. Reserve Bull. 829 (Oct. 30, 1989) (FRB approves application of commercial banks to engage in some brokerage activities); TAEHO KIM, INTERNATIONAL MONEY AND BANKING 242-43 (1995).

193. 12 C.F.R. § 9.18(b)(9)(ii) (1990).

194. Patman Report, *supra* note 21, at 1-4.

195. Clair & Tucker, *Interstate Banking and the Federal Reserve: A Historical Perspective*, FED. RESERVE BANK OF DALLAS ECON. REV., Nov. 1989, at 1, 6-12; TAEHO KIM, INTERNATIONAL MONEY AND BANKING 243-44 (1995); Jeffrey Clark, *Economies of Scale and Scope at Depository Financial Institutions: A Review of the Literature*, FED. RESERVE BANK OF KANSAS CITY ECON. REV., September-October, 1988, at 16-33.

196. *Id.*

197. Clair & Tucker, *Interstate Banking and the Federal Reserve: A Historical Perspective*, FED. RESERVE BANK OF DALLAS ECON. REV., Nov. 1989, at 1, 6-12; TAEHO KIM, INTERNATIONAL MONEY AND BANKING 230-232, & 291-292 (1995).

198. Bank Holding Company Act of 1956, § 4(c)(4)-(5), 12 U.S.C. § 1843(c)(5)-(6) (1998). Shares acquired in a fiduciary capacity are not included in the 5% limitation. *Id.*; TAEHO KIM, INTERNATIONAL MONEY AND BANKING 32, 230-232, 291-292 & 301 (1995).

banking company and cannot otherwise control an industrial firm.[199] Holding companies can own more than 5% (up to 25%), but only if the additional stock is nonvoting.[200]

B. *Mutual Funds*[201]

Mutual funds pool the investment funds of hundreds of investors, thereby enabling the individual investors both to diversify and to buy the investment expertise of the fund's managers, thus lowering its transaction costs.[202] In many economies in transition, it was assumed that these institutional investors might find monitoring corporate behavior necessary. The U.S. Congress was aware of this potential economic power as early as the 1930's. A 1934 Senate securities report[203] noted that only unscrupulous financiers mixed investment with control: "The investment company [has] become the instrumentality of financiers and industrialists to facilitate acquisition of concentrated control of the wealth and industries of the country."[204] As a consequence, Congress must "prevent the diversion of these [investment] trusts from their normal channels of diversified investment to the abnormal avenues of control of industry."[205] Congress might have "to completely divorce

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199. *Id.*; P. HELLER, FEDERAL BANK HOLDING COMPANY LAW § 4.03[2][b] (1990). Authority to own nonvoting stock of *public* companies was until recently largely illusory. Public companies could not issue nonvoting stock for most of the post-1956 era because of one-share, one-vote rules. NEW YORK STOCK EXCHANGE, NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL 3-11 to 3-14 (1990); Henry T.C. Hu & Bernard Black, *Empty Voting and Hidden Ownership: Taonomy, Implications, and Reforms* 1-5 (Working Paper, Feb. 2006), *available at* http://papers.ssrn.com/abstract=887183; TAEHO KIM, INTERNATIONAL MONEY AND BANKING 301 & 308-09 (1995).

200. *Id.* Authority to own nonvoting stock of *public* companies was until recently largely illusory. Public companies could not issue nonvoting stock for most of the post-1956 era because of one-share, one-vote rules.

201. For more details see BETTY LINN KRIKORIAN, FIDUCIARY STANDARDS IN PENSIONS AND TRUST FUNDS MANAGEMENT (1989).

202. FRANK FABOZZI & FRANCO MODIGLIANI, CAPITAL MARKETS: INSTITUTIONS AND INSTRUMENTS 65-72 (3d ed. 2003).

203. S. REP. NO. 1455, at 333-34 (1934) [hereinafter Pecora Report], *available at* http://72.14.203.104/search?q=cache:Ynt4fheIzJ4J:www.sechistorical.org/collection/papers/1940/1940_S3580_2/Part_2_63_pgs881_889.pdf+%22Pecora+Report%22+1934&hl=EN&gl=US&ct=clnk&cd=2.

204. Pecora Report, *supra* note 202, at 333-34.

205. *Investment Trusts and Investment Companies, Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong. 36 (1940).

investment trusts from investment banking."[206] Congress directed the SEC to draft legislation[207] which would provide that mutual funds should invest only passively.

1. *The Investment Company Act of 1940*

The SEC understood its marching orders from Congress. Its bill declared that "the national public interest . . . [is] adversely affected. when investment companies . . . [have] great size . . . [and] have excessive influence in the national economy."[208] The SEC wanted mutual funds' directors and employees off the boards of all portfolio companies, essentially a Glass-Steagall-type severance.[209] Enactment ultimately entailed compromise with the industry, but the SEC achieved much of its severance goal.[210]

A mutual fund cannot advertise itself as diversified if the regulated part of its portfolio has more than 10% of the stock of any company, even if that stock is a small portion of the fund's portfolio.[211] Only one-quarter of the portfolio is unregulated.[212] The SEC wanted that restriction to disable control.[213] The suspicion was that some mutual funds might have competed as monitors owning large blocks of stock. That prospect was cut off for diversified investment companies by

206. Pecora Report, *supra* note 202, at 393.

207. Public Utility Holdings Company Act of 1935, § 30, 15 U.S.C. § 79a-4 (1998).

208. 1940 Act Hearings, *supra* note 35, at 2. The statement of purpose also showed concern for efficient investment management and protection of investors. *Id.*; FRANK FABOZZI & FRANCO MODIGLIANI, CAPITAL MARKETS: INSTITUTIONS AND INSTRUMENTS 65-72 (3d. ed. 2003).

209. *Id.* at 216-20.

210. FRANK FABOZZI & FRANCO MODIGLIANI, CAPITAL MARKETS: INSTITUTIONS AND INSTRUMENTS 72 (3d. ed. 2003); Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2000); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll (2000).

211. Investment Company Act of 1940, § 5(b), 15 U.S.C. § 80a-5(b) (1998) [hereinafter 1940 Act].

212. *Id.*

213. See 1940 Act Hearings, *supra* note 35, at 188, 192 (statement of David Schenker, Chief Counsel, SEC Investment Trust Study); Pecora Report, *supra* note 202, at 348-51.

the 1940 Act.[214] Virtually all mutual funds call themselves diversified; although they cannot control public firms.[215]

The 1940 Act also prohibits a "diversified" mutual fund from putting more than 5% of its regulated assets in the securities of any one issuer.[216] Mutual funds are designed for unsophisticated investors who cannot assemble a diversified portfolio or evaluate the mutual fund's portfolio.[217] By requiring some standard of fragmentation if the fund chooses to call itself diversified, the 1940 Act helped make sure that investors got what they were promised. It should be noted that a large investment company could have a small portion of its assets in a single firm, but, hypothetically, if the portfolio firm were mid-sized, the investment company could have an influential block of stock.

2. *Subchapter M of the Internal Revenue Code*

The tax penalties for not being "diversified" are considerable. The mutual fund that would control industry would be taxed unfavorably on its entire portfolio, since the tax code allows only diversified mutual funds to pass income through to shareholders, untaxed to the conduit mutual fund.[218] Moreover, the tax code's notion of "diversification" parallels that

214. The SEC wanted more stringent control restrictions, including a bar on any fund exceeding $ 150 million in assets. The SEC also resisted recommending expanding the Internal Revenue Code's tax advantage for diversified funds (which could not own control blocks) to non-diversified funds (which could) and wanted to prohibit mutual fund directors from serving as directors of any portfolio company. 1940 Act Hearings, *supra* note 35, at 375, 400-01, 412.

215. *Id.*; Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2000); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll (2000).

216. 1940 Act, § 5(b)(1), 15 U.S.C. § 80a-5(b)(1) (1998).

217. *See* Pecora Report, *supra* note 202, at 348-51 (congressional criticism of mutual fund that put 19% of its assets into a railroad stock).

218. Joel Dickson, John Shoven & Clemens Siaim, *Tax Externalities of Equity Mutual Funds*, 53 NAT'L TAX J. 607, 611 (2000); I.R.C. § 851(b)(4) (1998). Subchapter M is available only to companies that derive 90% of their income from investment in stocks, bonds and other securities. I.R.C. § 851(b)(2) (1998). On the statute's face, there is a serious question whether a public company that intended to make most of its income from *management*, as opposed to passive investment, could obtain subchapter M pass-through at all. Investment Company Act of 1940, § 5(b), 15 U.S.C. § 80a-5(b) (1998). The "triple taxation" rules and the partnership rule are in *Id.* § 243, 1201 & 7704(c) (1998).

found in the 1940 Act;[219] it only faintly resembles the diversification concept taught in today's business schools. Under the tax code, mutual funds must have at least half of their investments in companies constituting no more than 5% of the portfolio and constituting no more than 10% of the portfolio company's outstanding stock; for the other half, no more than 25% of the fund's total assets can go into a single company's stock.[220]

If the fund chose not to be "diversified" under the tax code or the 1940 Act, its income would be taxed at the ordinary corporate tax rate, destroying the fund by a triple taxation of its income.[221] Income received by the noncomplying fund as dividends would be taxed twice, once at 34% when earned by the portfolio company, and then again when received by the fund.[222] True, the noncomplying mutual fund could exclude 70% of the dividends received, netting out to an effective tax rate of 10% on dividends.[223] Capital gains would

219. Daniel Bergstresser & James Poterba, *Do After-Tax Returns Affect Mutual Fund Inflows?* 1-4 (National Bureau of Economic Research, Working Paper, 2000); Joel Dickson, John Shoven & Clemens Siaim, *Tax Externalities of Equity Mutual Funds*, 53 NAT'L TAX J. 607, 611 (2000); Investment Company Act of 1940, § 5(b), 15 U.S.C. § 80a-5(b) (1998); I.R.C. § 851(b)(4) (1998). Subchapter M is available only to companies that derive 90% of their income from investment in stocks, bonds and other securities; and I.R.C. § 851(b)(2) (1998). On the statute's face, there is a serious question whether a public company that intended to make most of its income from *management*, as opposed to passive investment, could obtain subchapter M pass-through at all.

220. I.R.C. § 851(b)(4) (1998). Subchapter M is available only to companies that derive 90% of their income from investment in stocks, bonds and other securities; I.R.C. § 851(b)(2) (1998). On the statute's face, there is a serious question whether a public company that intended to make most of its income from *management*, as opposed to passive investment, could obtain subchapter M pass-through at all.

221. The "triple taxation" rules and the partnership rule are in *Id.* § 243, 1201 & 7704(c) (1998); Deborah L. Paul, *Triple Taxation*, 56 TAX LAWYER 1 (2003); Joel Dickson, John Shoven & Clemens Siaim, *Tax Externalities of Equity Mutual Funds*, 53 NAT'L TAX J. 607, 611 (2000).

222. The "triple taxation" rules and the partnership rule are in *Id.* § 243, 1201 & 7704(c) (1998); Joel Dickson, John Shoven & Clemens Siaim, *Tax Externalities of Equity Mutual Funds*, 53 NAT'L TAX J. 607, 611 (2000).

223. The "triple taxation" rules and the partnership rule are in *Id.* § 243, 1201 & 7704(c) (1998); Joel Dickson, John Shoven & Clemens Siaim, *Tax Externalities of Equity Mutual Funds*, 53 NAT'L TAX J. 607, 611 (2000); Daniel

be taxed at 34%.[224] And the income would be taxed a third time when realized by shareholders.[225]

This triple taxation deters most ordinary corporations from acting as long-term, undiversified monitors (and deters most mutual funds from losing their "diversified" status).[226] A corporation might accept the unfavorable tax status in the short-run, as a prelude to a takeover and restructuring, but the corporation asserting control over the long-term would have to be confident it had unusually acute monitoring skills.[227] After all, if the corporation received half of its income in capital gains and half in dividends, then it would pay approximately 20% of its income in taxes.[228] A great deal of effective monitoring would be needed to make up for that initial penalty. Nor could a public fund organize itself as a partnership to pass through its income to owners without itself paying tax.[229] To get pass-through tax status, a publicly traded partnership must also comply with subchapter M's portfolio restrictions.[230]

Thus, if a mutual fund wished to sell services as an intermediary/monitor, dividing its portfolio into three or four stocks, it could not get the advantage of subchapter M.[231] And no subchapter M mutual fund could ever threaten a portfolio company that the fund would devote more than a quarter of its assets to obtain a majority of the portfolio company's stock

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Bergstresser & James Poterba, *Do After-Tax Returns Affect Mutual Fund Inflows?* 1-4 (National Bureau of Economic Research, Working Paper, 2000).

224. *Id.*

225. *Id.*

226. The "triple taxation" rules and the partnership rule are in *Id.* § 243, 1201 & 7704(c) (1998); Joel Dickson, John Shoven & Clemens Siaim, *Tax Externalities of Equity Mutual Funds*, 53 NAT'L TAX J. 607, 611 (2000); Michael Barclay, Neil D. Pearson & Michael S. Weisbach, *Open–End Mutual Funds And Capital Gains*, 49 J. FIN. ECON. 4, 4-10 (1998).

227. *Id.*

228. *Id.*

229. The "triple taxation" rules and the partnership rule are in *Id.* § 243, 1201 & 7704(c) (1998); Joel Dickson, John Shoven & Clemens Siaim, *Tax Externalities of Equity Mutual Funds*, 53 NAT'L TAX J. 607, 611 (2000).

230. The "triple taxation" rules and the partnership rule are in *Id.* § 243, 1201 & 7704(c) (1998).

231. *Id*; Joel Dickson, John Shoven & Clemens Siaim, *Tax Externalities of Equity Mutual Funds*, 53 NAT'L TAX J. 607, 611 (2000); and I.R.C. § 851(b)(4) (1998).

and oust management.[232] That threat, and the influence it would yield, is prohibitively expensive for a mutual fund.[233]

3. *Other Restrictions on Control*

For that quarter of the fund that could be concentrated, other restrictions apply. If a mutual fund owned 5% of a portfolio company's stock or sat on its board, the portfolio firm would become a statutory affiliate of the mutual fund and of the mutual fund's principal underwriter.[234] Many mutual funds are sponsored by investment banks.[235] A sponsoring investment bank could not sell securities to the affiliate industrial company without an SEC exemptive order.[236] Moreover, if the mutual fund wanted to assert control jointly with any affiliate – defined as any company also owning 5% of a portfolio company – it would need prior SEC approval.[237] In effect, these rules discourage supervision by mutual funds.[238]

C. *Insurance Companies*

The large life insurance companies in the US play a limited role in American life. In 1906, New York prohibited life insurance companies from buying stock.[239] The prohibition affected most insurance companies, since more than half of insurance assets were in New York insurers.[240] In 1951, 3% of the company's assets could go into stock.[241] Today 20% of a

232. *Id.*

233. *Id.* § 851(b)(4)(B) (1998). Nor can mutual funds readily issue senior securities to enhance absolute size, and hence the size of its holding of any single company. 1940 Act, § 18(a), 15 U.S.C. § 80a-18(a) (1998).

234. 1940 Act, § 2(a)(3), 15 U.S.C. § 80a-2(a)(3) (1998); 17 C.F.R. 270.17a-6 (1990).

235. Joel Dickson, John Shoven & Clemens Siaim, *Tax Externalities of Equity Mutual Funds*, 53 NAT'L TAX J. 607, 611 (2000).

236. 1940 Act, § 2(a)(3), 15 U.S.C. § 80a-2(a)(3) (1998); 17 C.F.R. 270.17a-6 (1990).

237. 1940 Act, § 17(a)(1)-(2), 15 U.S.C. § 80a-17(a)(1)-(2) (1998). There are some exceptions. *See Id.*, § 17(b), 15 U.S.C. § 80a-17(b) (1998).

238. *Id.*

239. Act of Apr. 27, 1906, ch. 326, 1906 N.Y. Laws 763, 797.

240. *Id.*

241. Act of Mar. 31, 1951, ch. 400, § 5, 1951 N.Y. Laws 1065, 1070. In 1951, New York law governed 85% of the insurance industry's assets. Bell & Fraine, *Legal Framework, Trends, and Developments in Investment Practices of Life Insurance Companies*, 17 LAW & CONTEMP. PROBS. 45, 46 (1952).

life insurer's assets, or one-half of its surplus, can go into stock.[242] But even today insurers cannot take influential blocks; New York life insurers cannot put more than 2% of the insurance company's assets into the stock of any single issuer,[243] and property and casualty insurers cannot control a non-insurance company.[244]

Although the state of incorporation sets the major rules in corporate law, the state where the policy is sold sets insurance law.[245] State insurance law has two implications here. First, reincorporating an insurer in a small state with more favorable rules does little good, since the small state has few buyers of the insurance.[246] Second, insurers are often governed by several states and insurance companies must comply with the most restrictive regulation.[247] New York law governs 58% of the life insurance industry's assets and 82% of the property and casualty industry's assets. And other states have similar rules. California, Illinois, and Texas prohibit life insurers from investing more than 10% of the insurer's capital and surplus in any single company.[248] Approximately forty states limit stock to between 2% and 25% of the insurer's assets.[249]

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242. N.Y. Ins. Law § 1405(a)(6), (8) (McKinney 1985 & Supp. 1990).

243. *Id.* § § 1405(a)(6)(i), 1705(a)(1)-(2). In the 1980s, New York expanded the permissible activities of life insurer subsidiaries. But portfolio rules still limit them: a subsidiary's goodwill is carved out from coverage tests (*Id.* § § 1302(a)(1), 1414(f), no more than 2% of a life insurer's assets can go into any subsidiary, and no more than 5% of a life insurer's assets can go into non-New York subsidiaries. (Another 5% can go into New York subsidiaries.) Ownership of as little as 5% + of the portfolio company could trigger classification as a subsidiary, thereby triggering the goodwill carve-out and the overall 5% limit on deployment of the life insurer's assets. *Id.* § 107(a)(40). And finally, networking with banks is limited, since insurance companies cannot own banks. *Id.* § 1701(a).

244. *Id.* §§ 107(a)(40), 1403(c), 1404(a)(13)(B)(i) (no more than 5% of portfolio company's voting stock), 1407(a)(4), 1600-12 (only insurance subsidiaries).

245. See N.Y. Ins. Law § 1413 (McKinney 1985 & Supp. 1990) (non-New York insurers must substantially comply with New York law if the insurer wishes to sell policies to New Yorkers).

246. *Id.*

247. *Id.*

248. Cal. Ins. Code § § 1198, 1199 (West 1972); Ill. Ann. Stat., ch. 73, § 737.12(a)(c) (Smith-Hurd Supp. 1990); Tex. Ins. Code Ann. § 3.39.C.3 (Vernon 1981).

249. McCown & Martinie, *State Regulation of Life Insurance Companies*, 27 A. LIFE INS. COUNS. PROC. 8 (1998).

D. *Pension Funds*

Pension funds are the newest, least regulated of the financial institutions.[250] Although they have fewer assets under their control than banks and insurers, a large portion is in common stock.[251] Nevertheless, the structure of pension funds inhibits them from acting as monitors.

Pension funds are themselves fragmented; each company typically sets up its own fund, often giving money to several managers, who receive money from several companies. Since the Employee Retirement Income Security Act of 1974 ("ERISA") generally requires each fund to be diversified,[252] there is little room for an influential position in an operating company.[253] ERISA allows deviation from diversification only if "*clearly* prudent not [to minimize] the risk of large losses."[254] ERISA enhances the standard of care for plan operators to that of an expert: they must act "with the care, skill, prudence, and diligence . . . that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[255] A plan operator could not get very far in front of the pension manager crowd. Pension managers who took seats on the boards of portfolio companies would run the risk that their actions would be judged in a lawsuit by beneficiaries not by the low-level scrutiny of the business judgment rule, but by ERISA's higher standard of care.[256]

Of greater significance is the control that a plan sponsor's management has over the investment managers of the pension fund. Senior managers hire the people who run the com-

250. FRANK FABOZZI & FRANCO MODIGLIANI, CAPITAL MARKETS: INSTITUTIONS AND INSTRUMENTS 74-78 (3d ed. 2003).

251. *Id.*

252. ERISA, § 404, 29 U.S.C. § 1404 (1998); *see also* FRANK FABOZZI & FRANCO MODIGLIANI, CAPITAL MARKETS: INSTITUTIONS AND INSTRUMENTS 72 (3d ed. 2003); Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2000); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll (2000).

253. *Id.*

254. ERISA, § 104(1)(C), 29 U.S.C. § 1104(1)(c) (1998) (emphasis added).

255. ERISA, § 104(1)(B), 29 U.S.C. § 1104(1)(B) (1998).

256. *See* BETTY LINN KRIKORIAN, FIDUCIARY STANDARDS IN PENSION AND TRUST FUND MANAGEMENT 290-91 (1989).

pany's pension.[257] Pension managers who took an active role in overseeing the operating managers of another company could expect to incur the ire of their own company's senior managers.[258] The senior managers' control of their company's pension managers limits the ability of private pension funds to control companies.[259]

Thus, the one institution that is substantially unregulated in its ability to invest in large blocks of equity securities is controlled by operating company managers. This confluence might not be accidental.

IX.
SUMMARY OF RESULTS

Since it is clear from the literature that the financial institution investor group – composed of banks, mutual funds, insurance companies and pension funds – are all legally limited in their role as monitoring agents. Despite the changes in the past 20 years allowing for financial institutional investors to play a more crucial role in stock markets, they have, in fact, contrary to popular belief, all been limited by the legal system in their role as monitoring agents.

I found that portfolio rules, anti-networking rules, and other fragmenting rules disable financial institutional investors from systematically taking control blocks. Moreover, banks and bank holding companies have repeatedly been prohibited from owning control blocks of stock or from affiliation with investment banks that did. In addition, insurance companies were for quite some time prohibited from owning any stock, and portfolio rules still restrict their ability to take control. Furthermore, mutual funds cannot deploy more than a fraction of their portfolio in a concentrated position; buying more than 5% of a company triggers onerous rules.[260] Pension funds, on the other hand, are less restricted, but they are fragmented; rules make it difficult for them to operate jointly to assert control (although occasionally there are exceptions i.e. Eisner ouster from Walt Disney Co). And finally, private pen-

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257. S. REP. No. 144, at 53-58 (1986).
258. *Id.*
259. *Id.*
260. 1940 Act, § 2(a)(3), 15 U.S.C. § 80a-2(a)(3) (1998); 17 C.F.R. 270.17a-6 (1990).

sion funds are under management control; they are not constructed for a palace revolution in which they would assert control over their managerial bosses.

It is clear that the current framework for financial institutional investors as "backup" guardians to shareholder interest is lacking, thus the next step is to explore alternative legislative solutions to the current crisis for issues, such as, CEO salary, compensation, stock options, accounting standards, and role and evaluations of Board of Directors while trying to not compromise the inherent strengths of the American corporate governance system.